RELEARNING THE LESSON: IRS JUDICIAL DOCTRINE ATTACKS ON THE CAPTIVE INSURANCE COMPANY PRE-PLANNED TAX DEDUCTIBLE LIFE INSURANCE TAX SHELTER

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SUMMARY

There are certain members of the life insurance industry that are in perpetual pursuit of the ultimate potential driver of life insurance sales-tax-deductible life insurance premiums. Some in this industry have previously used aggressive retirement plan funding, and numerous other tax vehicles for these purposes, but in the end the IRS has always succeeded in defeating such strategies through administrative enforcement and litigation. The latest attempt to achieve tax-deductible premiums is the formation of a small business captive insurance company ("CIC") for the pre-planned purpose of using the CIC funds to invest in life insurance. The owner of a small business forms an IRC § 831(b) CIC, and pays a presumably tax-deductible premium to the CIC for business risk insurance issued by the CIC. Subsequently, the CIC uses a significant part of the tax-free premium immediately to purchase life insurance on the common owner of the small business and CIC. In general, life insurance premiums are not deductible as ordinary and necessary business expenses, and tax-deducted funds should not be used to purchase life insurance. The IRS is likely to view the CIC created and funded for the primary purpose of purchasing personal life insurance for its owner, as an abusive tax shelter. The IRS would see this transaction as the CIC serving as a conduit for the life insurance premiums to follow a circuitous route to achieve the tax deduction. The IRS often argues that judicial tax doctrines should be applied to disallow claimed deductions on what the IRS perceives to be Congressionally unintended life insurance oriented abusive tax shelters. In attacking the CIC pre-planned life insurance transaction, the IRS would likely utilize the following judicial doctrines: (1) the sham transaction doctrine (specifically, as a sham in substance); (2) the economic substance doctrine; (3) the doctrine of substance over form; and (4) the step transaction doctrine. This article discusses (a) the history of these judicial doctrines in general and specifically in life insurance cases; (b) a distillation of the rules derived from these cases that may apply to prospective life insurance tax shelters; and (c) the likelihood of IRS being successful in applying these judicial doctrines to defeat this latest

attempt by some in the life insurance industry at creating tax-deductible insider personal life insurance premiums.

I. INTRODUCTION: A SHORT HISTORY OF THE USE OF TAXATION AS A MOTIVATING FORCE IN THE LIFE INSURANCE SALES BUSINESS

Life insurance is an important social safety net, protecting families against the loss of a breadwinner in often the most troubling of times. Without life insurance, this responsibility would likely fall on taxpayers via governmental assistance programs. In addition, many people make use of life insurance as a form of retirement fund for use later in life. As such, life insurance companies have substantial investable assets in the form of life insurance reserves and retirement fund holdings that provide substantial liquidity in the US financial markets.[1] These functions, among others, are considered very important to the stability of the US economy. To foster and encourage the continuation of these purposes, Congress provides substantial tax incentives for people to purchase, hold, and invest in life insurance policies.[2]

Internal Revenue Code ("I.R.C.") § 101(a) provides that death benefit proceeds of a life insurance policy paid to a beneficiary by reason of the death of the insured is tax-free to the recipient beneficiary.[3] Furthermore, the I.R.C. allows for tax-free internal build-up on the investment accounts for certain permanent life insurance policies.[4] This tax-free internal build-up is essentially a retirement account whose investments grow untaxed until retirement.[5] Congress has allowed the investment gain from the internal build-up to be deferred until the policy is cashed-out, and completely and forever excluded from income if the policy is held until the death of the insured.[6]

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1. *Insurance Asset Management: Internal, External or Both?*, NAT'L ASSOC. OF INS. COMM'RS (Aug. 26, 2011), http://www.naic.org/capital_markets_archive/110826.htm.

2. *See* I.R.C. § 101(a) (2012); *See generally* I.R.S. Tech. Adv. Mem. 200213010 at 7 (Mar. 29, 2002) ("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.").

3. I.R.C. § 101(a).

4. I.R.S. Tech. Adv. Mem. 200213010 at 7.

5. *See generally id.*

6. *See* DAVID L. BRUMBAUGH, CONS. RESEARCH SERV., RS20923, TAXES AND THE "INSIDE BUILD-UP" OF LIFE INSURANCE: RECENT ISSUES 1 (2006).

Historically, life insurance companies and life insurance agents have made substantial life insurance sales by selling policies for estate planning purposes.[7] The life insurance proceeds can be used to pay the US Federal Estate Taxes ("Estate Tax")[8] due at death on the transfer of the fair market value of estate assets,[9] especially where significant assets are illiquid (such as a family business).[10] However, given that the amount of assets that can be transferred free of Estate Tax has risen steadily over the last decade (over $5 million individually, over $10 million for a couple in 2012),[11] the need for life insurance in estate planning has significantly reduced.[12] However, as the Estate Tax declined as a driver of life insurance sales, some in the industry have sought to use income tax incentives as a reason for taxpayers to purchase life insurance policies.

Some in the life insurance industry have unsuccessfully attempted to construct several arrangements to garner tax-deductible life insurance premiums or to provide tax-deductible financing for the purpose of purchasing life insurance.[13] However, the IRS is very skeptical of any attempt by taxpayers to garner additional and arguably legislatively-unintended tax benefits since Congress has already granted the aforementioned valuable tax subsidies to the life insurance industry.[14] The end result for the taxpayer participants in such arrangements was

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7. *See generally* Marsha Goetting, *Life Insurance: An Estate Planning Tool*, MONTGUIDE at 1, Apr. 2013, *available at* http://msuextension.org/publications/FamilyFinancialManagement/MT199211HR.pdf (Explaining how "life insurance can meet a variety of estate planning goals, provides hints about designation of beneficiaries, and describes the types of life insurance").

8. *See* I.R.C. § 2001 (2012) (describing Federal Estate Taxes & rate schedule).

9. Goetting, *supra* note 7, at 1.

10. *See id.*

11. *See* I.R.C. § 2010(c)(3), (4).

12. Econ. Growth & Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

13. I.R.C. § 831(b); *See generally id.* § 419 (providing for taxation of welfare benefit plans, that is, employee benefits other than retirement benefits, such as medical benefits, unemployment benefits or vacation benefits); Neonatology Assocs. v. Comm'r, 115 T.C. 43, 53-57 (2000); Curcio v. Comm'r, 99 T.C. Mem. 2010-115, at 23; I.R.S. Notice 2002-70, 2002-2 C.B. 765; Donald Arthur Winslow, *Tax Avoidance and the Definition of Insurance: The Continuing Examination of Captive Insurance Companies*, 40 CASE W. RES. L. REV. 79, 86 (1990); William P. Elliott, *A Guide to Captive Insurance Companies (Part 3) – IRS Proactivity in Captive Taxation*, 16 J. INT'L TAX'N 34, 41 (2005).

14. *See* I.R.S. Tech. Adv. Mem. 200213010 at 7 (Mar. 29, 2002).

generally expensive litigation, unfavorable results, and even accuracy-related penalties.[15]

The latest attempt to provide an income tax incentive for the purchase of life insurance has been the creation of captive insurance companies ("CIC") by small business owners (ostensibly for insuring business risks), for the purpose of having the CIC invest in life insurance on the CIC/business owner's life.[16] The theory behind this arrangement is that the small business owner's funding of the CIC may be treated as an ordinary and necessary tax-deductible business expense under I.R.C. § 162, allowing CIC premiums to be made with untaxed funds.[17] In the context of an I.R.C. § 831(b) CIC,[18] up to $1.2 million in annual premiums paid would also be excluded from the taxable income of the CIC.[19] Theoretically, the CIC could then purchase the pre-planned life insurance on the small business owner's life with pre-tax dollars as an investment.[20] Although these separate steps each meet the formalities of the I.R.C., the IRS may still attack these arrangements under various judicial doctrines designed to combat abusive tax structures.[21] These judicial doctrines include, but are not limited to, the "sham transaction doctrine;"[22] the "economic substance doctrine;"[23] the "step transaction doctrine,"[24] and the doctrine of "substance over form."[25]

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15. *See* I.R.S. Ann. 2002-96, 2002-2 C.B. 756; *Neonatology Assocs.*, 115 T.C. at, 97-102; Neonatology Assocs. v. Comm'r, 299 F.3d 221, 223 (3rd Cir. 2002).

16. *See* Jay Adkisson, *Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance*, http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm (last visited Feb. 10, 2014).

17. *See* I.R.C. § 162(a) (2012); Adkisson, *supra* note 16.

18. I.R.C. § 831(b).

19. *See id.*

20. Adkisson, *supra* note 16.

21. *Id.*

22. *See* Knetsch v. United States, 364 U.S. 361, 371 (1960); Gregory v. Helvering, 293 U.S. 465, 469 (1935); United Parcel Serv. of America, Inc. v. Comm'r, 254 F.3d 1014, 1020 (11th Cir. 2001); Winn-Dixie Stores, Inc. v. Comm'r (*Winn-Dixie II*), 254 F.3d 1313, 1316 (11th Cir. 2001); Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 96 (4th Cir. 1985); Dow Chem. Co. v. United States, 278 F. Supp. 2d 844, 853 (E.D. Mich. 2003); American Elec. Power, Inc. v. United States, 136 F. Supp. 2d 762, 766 (S.D. Ohio 2001); Winn-Dixie Stores, Inc. v. Comm'r (*Winn-Dixie I*), 113 T.C. 254, 294 (1999).

23. *See* Sala v. United States, 613 F.3d 1249, 1255 (10th Cir. 2010); IRS v. CM Holdings, Inc. (*In re* CM Holdings, Inc.), 301 F.3d 96, 108 (3rd Cir. 2002); *Winn-Dixie II*, 254 F.3d at 1316; Goldstein v. Comm'r, 364 F.2d 734, 742 (2d Cir. 1966); Gregory v. Helvering, 69 F.2d 809, 810-11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935); *Winn-Dixie I*, 113 T.C. at 294; ACM P'Ship v. Comm'r, T.C. Mem. 1997-115, at 88-89.

24. *See* Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945); Andantech L.L.C. v. Comm'r, 331 F.3d 972, 981 (D.C. Cir. 2003); Sec. Indus. Ins. Co. v. United States, 702 F.2d

The planned life insurance policy purchased by a small-business owner's CIC may appear to be for business purposes, but this insurance does not benefit anyone other than the small business owner and their family—making the premium expense arguably personal in nature. The IRS utilizes the aforementioned judicial tax doctrines to ensure compliance with Congressional intent that premiums paid on personal life insurance be non-deductible.[26] The IRS has a long history of successfully attacking life insurance arrangements that alter the form of transactions for the purpose of garnering legislatively unintended tax benefits.[27] Therefore, small business owners would be wise to take notice of the inherent risks involved with participation in such a pre-planned CIC life insurance arrangement.

This article: (1) provides an overview of life insurance tax policy; (2) discusses the elements and case law history of the various judicial tax doctrines used by the IRS to combat such arrangements; and (3) specifically analyzes how each judicial tax doctrine may be extended to a CIC arrangement formed for the primary purpose of purchasing life insurance on the CIC-funding small business owner's life.

II. THE IRS POLICY AGAINST TAX DEDUCTIBLE LIFE INSURANCE PREMIUMS

As a general rule, life insurance premiums are not deductible as ordinary and necessary business expenses, nor should tax-deducted funds be used to purchase life insurance.[28] The few exceptions to the general non-deductibility rule are very limited, including life insurance contained in certain qualified retirement plans, and deductible interest on up to $50,000 of loan interest expense on policies taken on key persons of the business.[29] However, taxpayers are prohibited from seeking to

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1234, 1247 (5th Cir. 1983); McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 525 (7th Cir. 1982); United States v. Mattison, 273 F.2d 13, 20 (9th Cir. 1959); King Enter., Inc. v. United States, 418 F.2d 511, 519 (Ct. Cl. 1969); Cal-Maine Foods, Inc. v. Comm'r, 93 T.C. 181, 203-5 (1989);.

25. *See* BB&T Corp. v. United States, 523 F.3d 461, 464 (4th Cir. 2008); Rogers v. United States, 281 F.3d 1108, 1115 (10th Cir. 2002); *Gregory*, 69 F.2d at 810.

26. HOWARD ZARITSKY & STEPHAN LEIMBERG, TAX PLANNING WITH LIFE INSURANCE ¶ 2.08 (2d 2011); I.R.C. § 264(a)(1) (2012).

27. *See generally* Neonatology Associates, P.A. v. Comm'r, 115 T.C. 43 (2000); Curcio v. Comm'r, T.C. Mem. 2010-115, at 21; I.R.S. Notice, 2002-44 I.R.B. 765; Winslow, *supra* note 13, at 89; Elliott, *supra* note 13, at 36.

28. *See generally* I.R.C. § 264(a)(1); ZARITSKY & LEIMBERG, *supra* note 26, at 2.08.

29. I.R.C. § 264(e).

deduct life insurance premiums beyond these few limited cases.[30] Congress has enshrined this tax policy into the I.R.C.,[31] and has defended this position in litigation against taxpayers.[32] The IRS has warned that it will "vigorously" pursue taxpayers who claim invalid ordinary business expense deductions associated with the purchase of life insurance,[33] and will seek the imposition of accuracy-related taxpayer penalties as a deterrence mechanism on taxpayers in appropriate cases.[34] The IRS has taken a tough stance against tax-oriented insurance schemes because the life insurance industry has already received preferential tax treatment in the forms of deferring gain on inside build-up[35] and a tax-free distribution to beneficiaries payable by reason of death of the insured.[36]

Inside build-up is a feature of permanent (whole and variable) life insurance policies, whereby the insurance company will increase the accumulated cash redemption value of the policy, similar to an interest-bearing bank account.[37] Inside build-up occurs when policy premiums paid-in exceed the amount required to pay for the cost of insurance during the premium period.[38] Thus, inside build-up adds a tax-free investment and savings component to permanent life insurance.[39] Such inside build-up results in tax benefits, since the built-up gain is either: (1) deferred until the insurance policy is surrendered for cash (prior to the death of the insured), or (2) completely excluded from income as part of the death benefit payment described below.[40] If a policyholder surrenders the policy for cash prior to the insured's death, the policyholder would be taxed on the difference between the policy's cash value, and the value of insurance premiums already paid and allocated towards insurance risk.[41]

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30. *Id.* § 264(a)(1).
31. *Id.*
32. *See* Giannaris v. Comm'r, T.C. Summ. Op. 2009-114, at 1.
33. I.R.S. Ann., 2002-43 I.R.B. 756.
34. *See generally* Neonatology Associates, P.A. v. Comm'r, 115 T.C. 43, 51 (2000).
35. I.R.C. § 72(e)(5)(A) (2012).
36. *Id.* § 101(a)(1) (excluding death benefits from income).
37. I.R.S. Tech. Adv. Mem. 200213010 (March 29, 2002).
38. Sanford Ellowitz, *What is Whole Life Insurance and How Does it Work?*, COMPUQUOTES.COM (April 11, 2010), http://www.compuquotes.com/whole-life-insurance/guides/What-Whole-Life-Insurance-How-Does-it-Work.html.
39. *Id.*
40. Brumbaugh, *supra* note 6, at 1.
41. *Id.* at 1-2.

When property is transferred from the estate of the deceased, the recipient receives a "stepped-up" basis to the property's fair market value as of the date of the deceased's death.[42] The "stepped-up" basis causes the accumulated capital appreciation in the property at the time of the deceased's death to go permanently untaxed under the income tax.[43] The primary policy reason for stepping up basis is the avoidance of perverse income tax consequences.[44] The Federal Estate Tax is imposed on the fair market value of property transferred at death.[45] Thus, if there were no stepped-up basis at death, the government could receive a windfall by receiving income tax on the excess of the death benefit over the premiums and other amounts paid, in addition to any estate tax.[46]

The life insurance industry and millions of individual policyholders share the benefit of: (a) inside build-up, and (b) death benefit tax breaks.[47] The public policy behind providing such favorable tax treatment incentives for taking out life insurance is encouraging families to protect themselves financially from the unexpected loss of a provider.[48] The combination of a tax deduction on the original insurance investment, tax-free investment growth on the deducted premiums, and tax-free transfer and receipt of the final death benefit, would essentially provide taxpayers with the opportunity to escape taxation completely on otherwise-taxable income by shifting it to policy premiums.[49]

III. THE CAPTIVE INSURANCE COMPANY AS A LIFE INSURANCE VEHICLE

A CIC is a corporation created to offer insurance to companies that are related parties to the CIC, often where the

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42. I.R.C. § 1014(a) (2012).

43. WILLIAM G. GALE & JOEL SLEMROD, RETHINKING ESTATE AND GIFT TAXATION: OVERVIEW 1, 7-8 (2001).

44. *See id.* at 24; *see also* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 41.4.7 (3rd ed. 1999) ("These rules are intended to prevent taxpayers from stepping up the basis of appreciated property by giving the property to someone near death, with the expectation that the property or the proceeds of its sale will be returned by bequest or inheritance on the donee's death.").

45. I.R.C. § 1014(a); *see id.* § 2001(a).

46. Id. §§ 2001-2058.

47. *See* Seth Hanlon & Jordan Eizenga, *Tax Expenditure of the Week: Tax-Free "Inside Build-up" of Life Insurance*, CENTER FOR AMERICAN PROGRESS (Mar. 30, 2011), http://www.americanprogress.org/issues/2011/03/te_033011.html.

48. *Id.*

49. *See* I.R.S. Tech. Adv. Mem. 200213010 (Mar. 29, 2002).

CIC owners also own the insured company.[50] The non-tax benefits of a CIC include premium cost stabilization; elimination or reduction of brokerage commissions and marketing expenses; lower administrative costs;[51] the ability to provide niche coverage for a unique or specific risk that would not otherwise be transferable in the commercial insurance market; and the potential to control certain CIC investment decisions and portfolio management.[52] There are several tax benefits afforded I.R.C. § 831(b) CIC entities as well – as discussed in the next paragraph. For a CIC to achieve these tax benefits a CIC must be considered an "insurance company" and the arrangement must be considered an "insurance contract."[53] To meet the "insurance" requirements, each CIC with U.S. shareholders must use IRS safe harbors or otherwise show: (1) that it has properly shifted the risk of economic loss ("risk shifting") from the insured to the insurer; and (2) that the insurer has adequately distributed the risk among several insurance companies (or other unrelated entities) so that no particular insurance company (or entity) has all the risk for an economic loss.[54]

The tax benefit of an I.R.C. § 831(b) CIC are also extensive. Premiums paid to a CIC by its shareholder insured are generally deductible, similar to the deductibility of premiums paid on commercial insurance.[55] I.R.C. § 162(a) provides that there shall be allowed deductions on necessary and ordinary expenses incurred in carrying on a business,[56] and Treas. Reg. 1.162-1(a) states that business expenses include insurance premiums on policies covering certain business losses.[57] I.R.C. § 831(b) provides that certain electing insurance companies may receive tax-free annual premiums up to $1.2 million,[58] although the CIC would still be liable for tax on its investment earnings.[59] As

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50. Adkisson, *supra* note 16.

51. *See* Julie Goosman & Christine Lug, *Captivating! Captive Insurance Arrangements are Alive and Well*, 35 CORP. TAX'N 25, 28 (2008).

52. *Id.*

53. *See* Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835, 838 (6th Cir. 1995) ("Under the *Le Gierse* test, unless the transaction involves both 'risk shifting' . . . and 'risk distribution' . . . it is not insurance for the purposes of the Internal Revenue Code."); Treas. Reg. 1.162-1(a).

54. Humana, Inc. v. Comm'r, 881 F.2d 247, 251 (6th Cir. 1989).

55. *See* I.R.C. § 162(a) (2012); Treas. Reg. §1.162-1(a) (as amended in 1993) ("Business expenses deductible from gross income include . . . insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business . . . .").

56. I.R.C. § 162(a).

57. Treas. Reg. § 1.162-1(a).

58. *See* I.R.C. § 831(b)(1), (b)(2)(A)(i).

59. *See id.* § 831(b)(1).

such, the shareholder insured deducts the premium payments, the CIC receives the premium payments tax-free, and will not be taxed on the premiums until the CIC makes a dividend distribution or the CIC stock is sold – either of which would currently be at long-term capital gains rates (20%)[60] instead of ordinary income rates (for purposes of this article, this rate shall be presumed to be 35%).[61]

A small business may create a CIC for the insurance of business risks. The theory behind this arrangement is that the small business owner's funding of the CIC may be treated as an ordinary and necessary business expense under I.R.C. § 162.[62] An ordinary and necessary business expense is tax deductible, so the CIC premiums are paid with pre-tax dollars from the small business.[63] In the context of an I.R.C. § 831(b) CIC,[64] up to $1.2 million per year in premiums paid would be excluded from the taxable income of the CIC.[65] This means that a CIC receiving less than $1.2 million in annual premiums would only face taxation on investment income.[66] The CIC may then take the insurance premiums paid by the small business and invest those premiums in order to earn a rate of return necessary to ensure the payment of claims as they accrue.[67] Theoretically, the CIC could then make a pre-planned purchase of life insurance on the small business owner's life with pre-tax dollars as an investment.[68] As such, the CIC's pre-planned purchase of life insurance on the common owner of the insured entity and CIC (hereinafter referred to as the "Insurance Transaction") could result in a near perfect tax shelter for the policy owner – (1) deductible premiums into the life insurance policy; (2) tax-free build-up inside the life insurance policy; (3) a subsequent distribution of the life insurance policy at currently tax-advantaged capital gains rates; and (4) an income and estate tax-

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60. CIC underwriting income that has been held by the CIC for at least one year would be taxed to the parent entity, upon distribution, at the long-term capital gains rate, which is currently 20% (without any additions provided for by the Patient Protection and Affordable Care Act). *See* Rev. Proc. 2008-66, 2008-45 I.R.B. 1107.

61. *See* I.R.C. § 162; *id.* § 11(b).

62. *See id.* § 162(a).

63. *See id.*; Adkisson, *supra* note 16.

64. I.R.C. § 831(b).

65. *See id.*

66. Adkisson, *supra* note 16.

67. *See id.*

68. *See id.*

free payment of the life insurance proceeds upon the death of the insured.[69]

The IRS has historically attacked similar pre-planned tax-deductible life insurance arrangements under judicially crafted doctrines, including: (1) the sham transaction doctrine, (2) the doctrine of substance over form, (3) the step transaction doctrine, and (4) the economic substance doctrine.[70]

IV. JUDICIAL TAX DOCTRINES USED TO IMPLEMENT THE TAX POLICY

A general tax law principle is that purely formal distinctions cannot obscure the substance of a transaction.[71] Over the years, several judicial doctrines have been developed to deny certain transactions the intended tax benefits.[72] While it is possible to properly distinguish these doctrines from one another, they are oftentimes muddled together in court analysis due to significant doctrinal overlap.[73] These doctrines are flexibly used to broadly police abuses of the tax system, and hence are not subject to clear-cut bright-line rules.[74] Taxpayers are generally allowed to order their affairs in a tax beneficial manner, but taxpayers may not cross the line by engaging in tax-advantaged transactions that were statutorily unintended.[75] The main judicial doctrines used to ensure that transactions are taxed according to their substance include: (1) the sham transaction doctrine; (2) the step transaction doctrine; (3) the substance over form doctrine; and (4) the economic substance doctrine.[76]

A. *The Sham Transaction Doctrine*

There are two types of "sham transactions" — "shams in fact" and "shams in substance." Shams in fact are transactions in which the economic activity that purports to give rise to the

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69. *See id.*

70. Jerome B. Libin, *Congress Should Address Tax Avoidance Head-On: The Internal Revenue Code Needs a GAAR*, 30 VA. TAX REV. 339, 340 (2010) (listing judicial doctrines commonly used to combat tax avoidance schemes).

71. *Id.* at 341 (tracking the development of the "substance over form" doctrine).

72. *See, e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231, 246 (3d Cir. 1998).

73. United States v. Daugerdas, 759 F. Supp. 2d 461, 466 (S.D.N.Y. 2010).

74. *Id.* at 467 (noting that the "economic substance doctrine is not subject to an exclusive formulation").

75. Gregory v. Helvering, 293 U.S. 465, 469 (1935).

76. Libin, *supra* note 70, at 340.

desired tax benefit does not actually occur[77]—a mere paper transaction.[78] For these reasons, any transaction deemed a sham in fact would result in the disallowance of any tax benefits intended to be derived from the transaction.[79] Shams in substance are transactions that actually occurred, but which lack economic substance beyond the creation of tax benefits.[80] A sham in substance is often much more difficult to identify than a sham in fact.[81] An example of a sham in substance is a transaction which is entered into by a taxpayer to produce a loss, but where the taxpayer bears no real risk of loss arising out of the transaction due to the risk being eliminated through a third party guarantee.[82] Under such a scenario, the loss deduction would likely be disallowed as an impermissible sham in substance.[83] Given the increased difficulty of defining shams in substance, the rest of this section of the article will focus on such shams in substance.

A significant amount of confusion exists in the case law application of the sham transaction doctrine. In *Rice's Toyota World*, the court stated, "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists."[84] Therefore, the sham transaction doctrine consists of a two-part test. A sham transaction exists if: (1) the transaction is not motivated by business purpose outside of tax considerations (business purpose test), and (2) the transaction is without economic substance

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77. However, an exception to this rule exists where a transaction actually physically took place, but where the transaction was clearly "performed in violation of some of the background assumptions of commercial dealing, for example arms-length dealing at fair market values." Dow Chem. Co. v. United States, 278 F. Supp. 2d 844, 849 (E.D. Mich. 2003) (citing Horn v. Comm'r, 968 F.2d 1229, 1236 n.8 (D.C. Cir. 1992)).

78. Dow Chem. Co. v. United States, 278 F. Supp. 2d 844, 848 (E.D.Mich. 2003).

79. Shams in fact and shams in substance lack economic substance. Therefore, any intended tax benefits will be disallowed. *See, e.g.,* Falsetti v. Comm'r, 85 T.C. No. 19, 355 (1985) (holding a purported sale transaction to be a loan-not a sale, and thus a sham-and denying tax benefits related to the transaction).

80. United States v. Wexler, 31 F.3d 117, 124 (3d Cir. 1994); *see also* ACM Partnership v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998).

81. *See generally* Dow Chem. Co. v. United States, 250 F. Supp. 2d 748, 799 (E.D. Mich. 2003) (addressing the two types of sham transactions, though not comparing the two).

82. *See, e.g.*, Yosha v. Comm'r, 861 F.2d 494, 499-500 (7th Cir. 1988) (holding option straddles to be shams in substance, and thus disallowing loss deductions, because the broker insured the clients against market risk).

83. *See id.* at 499-500.

84. Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985).

because there is no real profit potential in the transaction (economic substance test).[85] In *Kirchman v. Comm'r*, the Eleventh Circuit Court of Appeals held that the business purpose test and the economic substance test are separate doctrines—only if neither test were satisfied would the transaction be considered sham.[86]

The economic substance test does not look at the subjective intent of the taxpayer.[87] Rather, the test simply analyzes whether the transaction is objectively likely to produce economic benefits aside from tax deductions.[88] On the other hand, the business purpose test analyzes the reasonable likelihood that a transaction will be profitable absent tax benefits, from both a subjective and objective viewpoint.[89] The court stated that sham transaction analysis should focus on the question of whether the transaction has economic effects other than the creation of tax benefits.[90]

> The question of whether a transaction has economic substance is a threshold issue designed to winnow out the most abusive tax shelters without engaging in the more difficult question of whether a transaction was profit-motivated. Therefore, in determining whether a transaction [is] a sham, the court should not address whether, in the light of hindsight, the taxpayer made a wise investment . . . . Instead, the court must address whether the taxpayer made a *bona fide* investment at all or whether he merely purchased tax deductions.[91]

The Eleventh Circuit has held that "the creation of genuine obligations enforceable by an unrelated party" shall display the characteristics of economic effect sufficient to entitle the transaction to respect under the tax code.[92] Furthermore, if

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85. *Id.* at 91.

86. Kirchman v. Comm'r, 862 F.2d 1486, 1492-1493 (11th Cir. 1989) (acknowledging that a taxpayer's subjective intent can pass sham scrutiny, but such analysis was not warranted under the circumstances).

87. *Id.* at 1492.

88. Bail Bonds By Marvin Nelson, Inc. v. Comm'r, 820 F.2d 1543, 1549 (9th Cir. 1987).

89. *See* Andantech L.L.C. v. Comm'r, T.C. Mem. 2002-97, at 130-131.

90. Rose v. Comm'r, 868 F.2d 851, 853 (6th Cir. 1989).

91. Dow Chem. Co. v. United States, 250 F. Supp. 2d 748, 800 (E.D. Mich. 2003) (alteration in original) (quoting Bryant, 928 F.2d 748, 749 (6th Cir. 1991)).

92. United Parcel Service of America, Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001).

Congress has explicitly bestowed a tax subsidy upon a transaction, it cannot be claimed that the transaction is sham simply because the transaction could not expect profits apart from the Congressionally intended tax benefits bestowed, otherwise the executive and judiciary branches would be taking with one hand what the legislature has given with the other.[93]

1. Historical Doctrine Cases

The classic sham transaction case is *Gregory v. Helvering*.[94] In *Gregory*, a taxpayer was seeking to sell certain assets from a wholly owned corporation.[95] To accomplish this goal, the taxpayer created a new corporation and transferred those assets from the old to the new corporation in exchange for all of the stock in the new corporation.[96] The taxpayer then chose to liquidate the new corporation in order to recognize capital gain from the liquidation.[97] If the taxpayer had simply sold the assets through the old corporation, the gain would have been subject to double taxation at the relevant corporate rate and individual dividend rate.[98] The *Gregory* court refused to recognize the reorganization under the sham transaction doctrine because the reorganization had no economic purpose other than to re-characterize income from the inevitable disposition of assets.[99] The transaction in *Gregory* was a sham because the taxpayer simply changed the paper status of the company holding the assets for the purpose of creating favorable tax treatment upon disposition of the assets.[100] Thus, from *Gregory*, it is clear that if a transaction has no economic purposes other than tax benefits, the transaction will fail the sham transaction doctrine.

In *Knetsch v. United States*, the IRS disallowed substantial prepaid interest expense deductions, under a sham transaction theory, even though unrelated third party obligations existed.[101] In *Knetsch*, the taxpayer paid an insurance company $294,570 in premiums for an annuity contract during the two taxable years

93. Sacks v. Comm'r, 69 F.3d 982, 992 (9th Cir. 1995).
94. ACM P'ship v. Comm'r, 157 F.3d 231, 246 (3d Cir. 1998).
95. Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).
96. *Id.* at 810.
97. *See id.* at 810.
98. *Id.* at 810.
99. *Id.* at 811.
100. *Id.*
101. Knetsch v. United States, 364 U.S. 361, 362 (1960).

involved.[102] The taxpayer then "received $203,000 back in the form of 'loans'" and claimed deductions on such 'interest' expense.[103] What the taxpayer "was ostensibly 'lent' back was in reality only the rebate of a substantial part of the so-called 'interest' payments."[104] The court reasoned that the loan was not genuine because "[t]he $91,570 difference [between the taxpayer's interest payments and loan receipts was] retained by the company as its fee for providing the facade of 'loans.'"[105] The $91,570 difference between the premiums paid and loans taken was supposed to fund a guaranteed cash value of $8,388,000 at maturity, which would produce monthly annuity payments of $90,171 or substantial life insurance proceeds in the event of early death prior to maturity.[106] However, this cash value was a complete fiction since the taxpayer's annual borrowings kept the net cash value low enough to preclude the payment of these annuity payments.[107] This fiction of cash value was used to disguise the payment of a fee for the creation of tax deduction.[108] The court reasoned that although certain single premium annuity loan arrangements could have economic substance, the arrangement in *Knetsch* was a sham since the unrelated third party obligation was not genuine and did "not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax."[109] The 1960 *Knetsch* case illustrates how the rule outlined in *Gregory* (1934) had developed after a few decades. The *Knetsch* court refines the sham transaction doctrine, such that a transaction fails for lacking in all non-tax economic purposes, but also where the obligations between unrelated parties are not bona fide and genuine.

In *Rice's Toyota World*, the taxpayer, a car dealer, purchased a used computer from a commercial equipment leasing company.[110] The car dealer gave the commercial leasing company a $250,000 recourse note and two non-recourse notes totaling $1,205,227.[111] The leasing company had previously

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102. *Id.* at 365.
103. *Id.*
104. *Id.* at 366.
105. *Id.*
106. *Id.* at 365.
107. *Id.* at 366.
108. *See id.*
109. *See id.* (quoting Gilbert v. Comm'r, 248 F.2d 399, 411 (2d Cir.)).
110. Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 90-91 (4th Cir. 1985).
111. *Id.* at 91.

purchased the computer for approximately $1.3 million.[112] The car dealer thereafter leased the computer back to the commercial leasing company for a period of eight years, whereby the leasing company was obligated to pay rent on the computer in an amount exceeding the amounts owed on the non-recourse notes.[113] The car dealer sought deductions for the accelerated depreciation on the computer and for the interest paid on the notes.[114] The IRS sought to disallow these deductions, under a theory that the purported sale-leaseback was a sham transaction.[115] The *Rice's Toyota World* court reasoned that the transaction was sham because the transaction had no subjective business purpose other than tax benefits and because, objectively, a similarly situated reasonable person would not expect to receive a profit from the transaction other than through the creation of tax benefits.[116] The court essentially found that the car dealer had not really purchased a computer, but had instead paid a fee to the commercial leasing company to avail itself of the leasing company's accelerated depreciation deductions and to create loan interest deductions stemming from the non-recourse notes.[117] The Fourth Circuit affirmed the tax court's ruling that the accelerated depreciation deductions should be disallowed since the taxpayer did not truly "purchase" the computer on which the deductions were taken.[118] However, the deductions for loan interest paid on the recourse notes were found to be valid since the debt was a genuine obligation between unrelated parties.[119] Therefore, it is entirely possible that a court may separate a transaction into parts, those lacking both independent business purpose and profit motive that fail the sham transaction doctrine, and those that are genuine obligations between independent transacting parties that survive the doctrine.[120] In the development of the sham transaction doctrine case law, the *Rice's Toyota World* court stands for the idea that even a transaction that creates bona fide obligations between unrelated parties may be deemed a sham, if (1) the transaction is not

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112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.* at 95.

116. *Id.* (affirming the reasoning of the tax court in Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184, 209-10 (1983)).

117. *Id.* at 94-95.

118. *Id.*; *see Rice's Toyota World*, 81 T.C. at 210.

119. *Rice's Toyota World*, 752 F.2d at 95-96.

120. *Id.* at 96.

subjectively entered into for non-tax business purposes, and (2) the transaction is not one that would objectively expect the receipt of a profit other than tax benefits.[121] These two caveat provisions (non-tax business purpose and pre-tax profit potential) are now mainly addressed as part of the economic substance doctrine (discussed below).

In *United Parcel Service of America v. Comm'r*, the taxpayer corporation (UPS) sought to restructure its customer package shipment insurance transactions.[122] UPS charged "excess value charges" ("EVCs") to each customer that purchased insurance and these charges created substantial revenue.[123] In order to restructure the insurance transactions, UPS agreed to reinsure the risk of such insurance obligations, using the EVCs to cover the premium payments owed to the independent reinsurer under this agreement.[124] The independent insurer further agreed to reinsure these risks with a UPS owned Bermuda-based captive insurance subsidiary to which the independent insurer would remit the EVCs less commission and fees.[125] The IRS argued that the transaction was sham because the transaction resulted in UPS retaining the risk while generating tax-deductible premium payments for the cost of fees and commissions to the independent reinsuring party.[126] The Eleventh Circuit Court of Appeals, in *UPS of America*, held that a transaction is not considered a sham where the transaction creates genuine obligations enforceable by an unrelated party.[127] The court reasoned that genuine obligations to third parties create economic substance in the transaction beyond mere tax benefits.[128] The *UPS of America* court found that the binding payment of fees and commissions to the unrelated intermediary was enough to circumvent the application of the sham transaction doctrine.[129] The *UPS of America* case illustrates the modern form of the sham transaction test, which has been largely decoupled from the economic substance test (discussed below). Of course, the IRS often raises both the economic

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121. *Id.* at 95.

122. United Parcel Serv. of Am., Inc. v. Comm'r (*UPS of America*), 254 F.3d 1014, 1018 (11th Cir. 2001).

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.* at 1017.

127. See *Id.* at 1018-20.

128. *Id.* at 1018-19.

129. *Id.*

substance doctrine and the sham transaction doctrine in the same case.[130] Where the part of the *Rice's Toyota World* ruling regarding subjective business purpose and pre-tax profit potential is separated into the judicial and codified economic substance doctrine, the rule in *Knetsch* remains in *UPS of America* for purposes of application of the sham transaction doctrine.[131] Overall, *UPS of America* stands for the proposition that a transaction fails the sham transaction doctrine if it does not create bona fide obligations between unrelated independent parties.

In sum, a transaction fails the sham transaction doctrine as a "sham in substance" if: (1) it has no economic purposes other than tax benefits; or (2) the obligations between unrelated parties are not bona fide and genuine. In the next section, this article will discuss how the general sham transaction doctrine rule has been applied to particular life insurance oriented cases.

2. Specific Life Insurance Cases

In the life insurance area, the sham transaction doctrine has often been raised to disallow deductible interest in Corporate-Owned Life Insurance ("COLI") cases. In *Winn-Dixie Stores, Inc. v. Commissioner*, a corporate taxpayer created COLI plans on 36,000 employees and funded the premium payments through loans on policy values.[132] The COLI program was designed so that annual premiums, fees, and policy loan interest would exceed the policies' projected annual death benefits and net cash values.[133] Because virtually the entire policy values were encumbered by loans, there was very little equity in the policies.[134] The program's design generated large amounts of deductible interest on the policy loans.[135] The income tax savings from the deductions for interest and fees were projected to be substantially in excess of the projected net costs of maintaining the COLI program.[136] In each year of operation, the COLI

130. *See, e.g.*, *Rice's Toyota World*, 752 F.2d at 96.

131. *See UPS of America*, 254 F.3d at 1019.

132. Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1314-15 (11th Cir. 2001) (summarizing facts found by tax court in Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254, 255-56 (1999)).

133. *Winn-Dixie*, 113 T.C. at 255-56.

134. *Id.*

135. *Id.*

136. *Id.* at 262-63.

program projected a pretax loss and an after-tax gain.[137] The taxpayer argued that the plan could produce tax-independent benefits if a catastrophic event produced large, unexpected death benefits, but the court viewed this improbable benefit as too remote to be economically significant.[138] Viewing the plan in its entirety, the *Winn-Dixie* court held that the COLI plans were sham transactions because the plan would produce negative earnings and negative cash flows every year without consideration of the tax benefits contemplated under the plan.[139] The *Winn-Dixie* court reasoned that any plan that has a sole function to reduce tax liabilities (absent incredibly remote circumstances) must be a sham.[140]

In *American Electric Power, Inc. v. United States* a corporate taxpayer engaged in a highly leveraged, broad-based COLI plan.[141] The taxpayer purchased life insurance on most of its 20,000-employee workforce, with the corporate taxpayer acting as the policy beneficiary.[142] A substantial amount of the premiums were financed by loans secured by the cash values of the policies.[143] The general rule is to disallow "deductions for interest paid on policy loans taken against a life insurance policy, 'which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value' of the policy."[144] However, the taxpayer sought to utilize an exception to the general rule — "the four-out-of-seven safe harbor."[145] The four-out-of-seven safe harbor provides an exception and allows deductions for interest paid on policy loans taken against a life insurance policy so long as "no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium . . . was paid) is paid under such plan by means of indebtedness."[146] In *American Electric*, a majority of the premiums were front-loaded in the first three years of the plan in order to allow for effective premium rebates in years four

137. *Id.*

138. *Id.* at 284-85.

139. *Id.* at 285.

140. *See id.*; *See also* Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316 (11th Cir. 2001) (discussing the court's conclusion that the COLI program had no other "function" than generating interest deductions).

141. Am. Elec. Power, Inc. v. United States, 136 F.Supp.2d 762, 765-66 (S.D. Ohio 2001).

142. *Id.*

143. *Id.* at 766.

144. *Id.* at 794. (quoting I.R.C. § 264(a)(3) (2012)).

145. *Id.* at 794; *see* I.R.C. § 264(d)(1).

146. *Id.* § 264(d)(1); *Am. Elec. Power*, 136 F.Supp.2d at 794.

through seven.[147] These premium payment policies aimed to create loan interest deductions and to accelerate premium payment deductions.[148] The COLI program, in general, attempted to maximize the deductibility of interest on the policy loans, defer inside build-up, and benefit from tax-free death benefits.[149]

The *American Electric* court analyzed the COLI plan under the sham transaction doctrine.[150] According to the court, a challenged transaction shall be analyzed as a whole, under the sham transaction doctrine, with each individual element of the transaction also analyzed to determine if the substance of the transaction is consistent with the transactional form.[151] If the form of the transaction complies with deductibility requirements, but the transaction lacks economic substance other than Congressionally unintended tax benefits created by the transaction, then expenses incurred with respect to the transaction are non-deductible.[152] A taxpayer may structure its activities to minimize tax liability. However, all transactions, when viewed individually or as an integrated whole, must have economic substance beyond the mere tax benefits created by the transaction in order to support the deductibility of expenses and losses incurred with respect to such transactions.[153] Furthermore, the burden of proof rests on the taxpayer to show that the form of a transaction matches its substance.[154]

Ultimately, the entire COLI plan in *American Electric* was found to be a sham in substance since: 1) the COLI plan was mortality neutral, and 2) the proposed policy loans, secured by cash value of the whole life policies, produced zero net equity throughout the life of the plan.[155] The *American Electric* court reasoned that mortality neutrality and zero net equity eliminated both potential economic benefits of whole life insurance: "1) a death benefit which exceeds the cost of insurance in the event of the premature death of the insured person and 2) the accumulation of tax-deferred inside buildup."[156] Therefore,

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147. *Am. Elec. Power*, 136 F.Supp.2d at 770.
148. *Id.* at 766.
149. *Id.*
150. *Id.* at 778.
151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.*
155. *Id.* at 787-88.
156. *Id.* at 787.

although the COLI plan purchased whole life insurance, the fact that the COLI plan was mortality neutral and proposed to carry zero net equity caused the COLI plan to function much like term insurance.[157] Thus, the *American Electric* court reasoned that it was improper for the taxpayer to claim premiums payable based on whole life insurance benefits ostensibly received when the taxpayer actually received something more akin to term coverage and a rebate.[158] An arrangement in which term life insurance coverage is disguised as whole life insurance is a sham since the arrangement exists solely to garner heightened tax benefits accorded to whole life products — i.e. increased premiums payable deductions and the deductibility of interest expense on loans secured by the policy's cash value if the policy meets the four-out-of-seven safe harbor requirements.[159] *American Electric* broadly stands for the proposition that the IRS will disallow as a sham a life insurance premium and loan back policy that seeks to garner the tax benefits Congressionally permitted for whole life policies where such premium and loan back policy circumvents the purpose of whole life insurance.[160]

In *Dow Chemical Co. v. United States*, a taxpayer corporation also claimed interest deductions on loans taken against COLI plans.[161] The interest payments were funded by circular dividend loading netting transactions.[162] The IRS challenged the scheme as a sham transaction.[163] Since the COLI plan in *Dow* involved actual transactions that did not violate background assumptions of commercial dealing, the impropriety of the transaction was analyzed under a sham in substance theory.[164] The IRS argued that the COLI plans, with corresponding loan interest payments funded through contributions to inside build-up of the insurance policies, were empty transactions because the polices were mortality neutral and the policy withdrawals caused there to be no expected profit (according to the net present value of the outlays produced).[165] The IRS further argued that the transactions essentially entailed

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157. *Id.* at 791.

158. *See generally id.* at 792–93.

159. *See generally id.* at 766-67 (discussing the availability of certain deductions under the Internal Revenue Code).

160. *See id.* at 778.

161. Dow Chem. Co. v. United States, 278 F.Supp.2d 844, 845 (E.D. Mich. 2003).

162. *Id.* at 849.

163. *Id.* at 845.

164. *Id.* at 850.

165. Dow Chem. Co. v. United States, 250 F.Supp.2d 748, 801-03 (E.D.Mich 2003).

a complex payment of fees in exchange for the creation of interest loan deductions.[166]

In addition to the economic substance doctrine (discussed below), the *Dow* court analyzed the transaction on sham in substance grounds.[167] The court looked at whether the COLI plans had real economic consequences aside from the tax benefits.[168] The *Dow* court quoted the Third Circuit Court of Appeals, stating that "choosing a tax favored investment vehicle is fine, but engaging in an empty transaction that shuffles payments for the sole purpose of generating a deduction is not."[169] The *Dow* court ultimately held that although the COLI plans involved significant withdrawals of inside buildup, they were not sham transactions because the plans continued to have significant financial effect after the COLI tax beneficial interest netting had ended.[170] The court focused on the following economic attributes that continued after the COLI tax benefits terminated: (1) the policies are still in force; (2) the policy loans remain outstanding; (3) the death benefits are still to be paid; (4) premiums continue to be paid by Dow; and (5) state taxes are still paid on the premiums. [171] The *Dow* decision stands for the proposition that life insurance transactions that are mortality neutral and contain zero net equity may not be considered sham transactions where there also exist substantial non-tax benefits outside of the dividend netting period.[172]

In sum, these cases stand for the proposition that tax deductions on whole life insurance policy transactions may be disallowed under the sham transaction doctrine, where there exists both mortality neutrality and zero net equity.[173] In such a case, the whole life policy ends up with the economic characteristics of a term life insurance policy, potentially defeating the purposes of whole life insurance.[174] Therefore, the use of a whole life vehicle for essentially term coverage may be deemed to have no economic effect other than the creation of non-

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166. *Id.* at 753.

167. *Dow Chem. Co.*, 278 F.Supp.2d at 852.

168. *Id.* at 852-53 (citing *Dow Chem Co.*, 250 F. Supp. 2d at 807, 810-11).

169. *Id.* (quoting IRS v. CM Holdings, Inc. (*In re* CM Holdings, Inc.), 301 F.3d 96, 105 (3d Cir. 2002)).

170. *Id.* at 852-53 (citing *Dow Chem Co.*, 250 F. Supp. 2d at 807, 810-11).

171. *Id.* at 848 (citing *Dow Chem Co.*, 250 F. Supp. 2d at 811-12).

172. *Id.* at 851-52.

173. *See* Am. Elec. Power, Inc. v. United States, 136 F.Supp.2d 762, 778 (S.D. Ohio 2001); Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316 (11th Cir. 2001); Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254, 278-79 (1999).

174. *See Am. Elec. Power*, 136 F.Supp.2d at 791.

legislatively intended tax deductions. Such a finding would cause the transaction to be disregarded, with any claimed deductions being disallowed.[175] However, even where dividend netting transactions cause mortality neutrality and zero net equity within a whole life insurance policy, the sham transaction doctrine challenge will likely fail where the policy provides for substantial non-tax benefits (like those referenced in *Dow*) to the taxpayer over the life of the policy[176], provided the probability of the non-tax benefit coming to fruition is not incredibly remote.[177]

3. Prospective Application of Doctrine to CIC Life Insurance Investment

If a captive insurance company ("CIC") is created for the purposes of investing in a life insurance policy taken out on the life of an owner and funder of the CIC, it is likely that such a transaction creates a legislatively unintended combination of tax benefits. The combination of benefits for such a transaction may be as follows: (1) the insured business would take insurance premium expense deductions on funds paid to the CIC for the insuring of business risks;[178] (2) an I.R.C. § 831(b) CIC would enjoy an exclusion from income on premiums paid up to $1.2 million annually;[179] (3) the inside build-up of the life insurance purchased by the CIC would enjoy deferred taxation; (4) the life insurance policy could be distributed at a reduced current tax rate of 20%; and (5) the entire death benefit (including inside build-up) could enjoy complete exclusion from the income of the distributed policy owner's beneficiaries.[180] This combination of benefits would mean that the CIC and insurance policy investment would be funded by pre-tax dollars, and the funds would only be subject to a one-time (currently 20%) tax on the distribution of the policy out of the CIC.[181]

A taxpayer's funding of a CIC is an actual transaction, as is the CIC taking out a life insurance policy on the funding owner's life. Therefore, the arrangement could only be challenged on a

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175. *See Dow Chem. Co.*, 278 F. Supp. 2d at 852.
176. *See id.* at 853.
177. *Winn-Dixie*, 113 T.C. at 285-86; *Winn-Dixie*, 254 F.3d at 1316.
178. I.R.C. § 162(a) (2012).
179. I.R.C. § 831(b).
180. *See* Brumbaugh, *supra* note 6, at 2.
181. *Id.* at 1.

sham-in-substance theory.[182] As discussed above, a sham-in-substance exists if: (1) it has no economic purposes other than tax benefits; or (2) the obligations between unrelated parties are not bona fide and genuine. [183] If analyzed on its own, a CIC's investment in life insurance likely creates a genuine obligation enforceable by an unrelated party; provided the life insurance contract is commercially reasonable and the life insurance company is not under common ownership or control with either the CIC, or the individual or entity funding the CIC.[184] If analyzed independently of the investment in life insurance, the funding of a CIC has the potential to fail as a genuine and enforceable third party obligation. However, if it fails on these grounds it also would fail to sufficiently shift risk of loss. Where a taxpayer does not sufficiently shift the risk of loss, the arrangement would not be considered "insurance," and premiums paid would be currently non-deductible.[185]

If viewed as an integrated transaction, a CIC formed primarily for the purpose of purchasing life insurance on the CIC funder's life could potentially be found to create non-genuine obligations. In *Knetsch*, the court held that interest paid on indebtedness to an unrelated third party was non-deductible as a sham-in-substance, because the indebtedness was not genuine and did "not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax."[186] The court's analysis focused on the existence of disguised fee payments and rebated payment.[187] The CIC life insurance arrangement could similarly be found to create non-genuine obligations where the collective steps are shown to be more akin to a purchase of life insurance by the funder and a disguised fee payment to the CIC for the creation of a tax deduction.[188] The taxpayer would likely argue that each component of the overall transaction meets the requirements of deductibility under the I.R.C. However, the general statutory rule that premiums paid on life insurance are non-deductible personal expenses[189] lends credence to the IRS's argument that

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182. *See* Dow Chem. Co. v. United States, 278 F. Supp. 2d 844, 848 (E.D. Mich. 2003) (referring to the transactions as "sham-in-fact").

183. *UPS of America*, 254 F.3d 1014, 1018 (11th Cir. 2001).

184. Lerman v. Comm'r, 939 F.2d 44, 48 n.6 (3d Cir. 1991).

185. Humana, Inc. v. Comm'r, 881 F.2d 247 (6th Cir. 1989).

186. *See generally* Knetsch v. United States, 364 U.S. 361, 365-66 (1960) (quoting Gilbert v. Comm'r, 248 F.2d 399, 411 (2d Cir. 1957)).

187. *See id.* at 366.

188. *See id.*

189. *See generally* I.R.C. § 264(a)(1) (2012) (disallowing a deduction to the taxpayer who is a beneficiary of the life insurance policy).

the combined tax benefits of a CIC and the pre-planned investment component of whole life insurance on the CIC owner's life are, together, Congressionally unintended.

In *American Electric*, the court found that the COLI plan was a sham-in-substance because the plan sought legislatively approved tax benefits for whole life insurance when the taxpayer only purchased the equivalent of term life insurance coverage.[190] The court reasoned that the combined effect of purchasing a whole life insurance policy and rebating the premiums through loans on the policy's entire cash value resulted in the purchase of a term life insurance product.[191] Essentially, the court found that the loan interest deductions were taken in a legislatively unintended manner, even though the transaction technically fit within the requirements of the four out of seven safe harbor provisions.[192]

Similarly, the CIC life insurance arrangement could be found to consist of a series of transactions that are independently valid, but collectively create a result that is not Congressionally intended.[193] The results of the overall CIC life insurance arrangement are identical to the CIC funder's direct purchase of life insurance, so the arrangement constitutes the purchase of non-deductible personal life insurance disguised as two separate legislatively approved transactions.[194] Obviously, the CIC life insurance arrangement more closely resembles the direct purchase of life insurance by the CIC funder when there exist few other investments by the CIC. However, a CIC must resemble a real insurance company to garner the tax benefits of I.R.C. § 831(b).[195] A real insurance company would not typically purchase life insurance on an insured's owner as an investment, and certainly not as its sole investment.[196] Real insurance companies make investment decisions that create a diversity of investments and which do not also directly benefit the owner of the insurance company personally.[197] Given that the CIC life insurance transaction results in legislatively unintended tax

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190. *See generally* Am. Elec. Power, Inc. v. United States, 136 F. Supp. 2d 762, 791 (S.D. Ohio 2001).

191. *See id.* at 792.

192. *See generally id.* at 783.

193. *See id.*

194. *See id.* at 776-77.

195. *See* I.R.C. § 831(b) (2012). *See also* I.R.C. §§ 831(c), 816(a) (defining insurance company).

196. *See* Adkisson, *supra* note 16.

197. *See id.*

deductible premium payments, and the fact that such an investment is not a transaction typically made by an independent insurance company, it is likely that the transaction as a whole creates a non-genuine obligation[198] that would be deemed a sham-in-substance.[199]

B. *Substance Over Form Doctrine*

The substance over form doctrine states that the tax results of a transaction should be determined based on the underlying substance of the transaction, rather than upon mere tax compliance with individual formalities along the way to the stated result.[200] Taxpayers are usually bound to the tax consequences of their chosen legal form, but a court may re-characterize a transaction according to its underlying substance.[201] In applying the substance over form doctrine, a court will look to the "objective economic realities of a transaction" rather than mere form.[202] The rationale behind the doctrine is that two transactions that achieve the same ultimate goal should not garner different tax treatment simply because the transactions follow different formal steps along the way.[203] The burden of proof rests on the taxpayer to show that the form of a transaction matched its substance.[204]

1. Historical Doctrine Cases

The *Gregory v. Helvering* case is a fundamental case in the formation of the substance over form doctrine, in the same way as it was for the development of the sham transaction doctrine (discussed above).[205] The facts of *Gregory* are provided above, *supra*, in section I.V.A.1. In *Gregory*, the court also analyzed the taxpayer's reorganization and liquidation under the substance over form doctrine, refusing to give effect to the scheme.[206] The *Gregory* court held that taxpayer's corporate reorganization was merely a scheme to disguise the true elaborate and devious

198. *See generally* Knetsch v. United States, 364 U.S. 361, 365-66 (1960).
199. *See generally Am. Elec. Power*, 136 F. Supp. 2d at 778.
200. Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).
201. *See* Comm'r v. Danielson, 378 F.2d 771, 774 (3d Cir. 1967).
202. Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978).
203. *Minnesota Tea Co.*, 302 U.S. at 613.
204. *Am. Elec. Power*, 136 F. Supp. 2d at 778.
205. Gregory v. Helvering, 293 U.S. 465, 470 (1935).
206. *See id.* at 468-69.

substance of the transaction.[207] The substance of the transaction was simply a sale of assets, not a reorganization and liquidation.[208] The two arrangements have very different tax consequences, but produce the same non-tax economic realities.[209] *Gregory* broadly stands for the proposition that where two different forms of the same economic transaction render one form significantly more tax beneficial than the other form (in violation of Congressional intent),[210] the court may disregard the tax benefits under the substance over form doctrine.[211]

The case of *Rogers v. United States* involved two equal co-owners (Fogelman and Kaufman) of the Kansas City Royals baseball team. Fogelman had previously acquired an option to purchase Kaufman's shares in the team.[212] Fogelman incurred substantial debts from his other business activities and needed to access some money out of his investment in the Royals to satisfy these other debts.[213] To accomplish this, Kaufman lent $34 million to the Royals, who then lent the $34 million to Fogelman.[214] In exchange, Fogelman granted the Royals a non-recourse note, secured by both Fogelman's share of the team and Fogelman's option to buy the remaining shares.[215] The court applied the substance over form doctrine, declaring that the substance of the transaction was a redemption sale of Fogelman's shares of the team rather than a business loan secured by the option and shares, for which ordinary and necessary business deductions could be taken.[216] The court reasoned that the transaction was, in substance, intended by the parties to be a redemption sale because the option exercise price provided a disincentive for repayment of the "loan."[217] If Fogelman repaid

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207. *See id.* at 469-70.

208. *See* Gregory v. Helvering, 69 F.2d 809, 811 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

209. *Id.* at 810-11.

210. The U.S. Supreme Court, in *Gregory*, found that "[t]he whole undertaking, though conducted according to the [statutory] terms . . . was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization." *See Gregory*, 293 U.S. at 470. *See also Gregory*, 69 F.2d at 810-11 ("[A] sentence may be more than that of the separate words, as a melody is more than the notes . . . . To dodge the shareholders' taxes is not one of the transactions [Congressionally] contemplated as 'reorganizations.'").

211. *See generally Gregory*, 69 F.2d at 810-11.

212. Rogers v. United States, 281 F.3d 1108, 1111 (10th Cir. 2002).

213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.* at 1122.

217. *Id.* at 1124.

the $20 million owed under the "loan," the Royals could immediately exercise the option to purchase Fogelman's interest for $14 million.[218] Applying the substance over form doctrine, the transaction is more accurately characterized as a redemption sale, because it simply makes no economic sense for Fogelman to repay the "loan."[219] The *Rogers* case broadly stands for the proposition that form will not control the tax consequences of a transaction where the economic realities are such that the transaction can only end in a manner consistent with a transactional substance contrary to the stated form.

In *BB&T Corp. v. United States*, a taxpayer entered into a "lease-in/lease-out" ("LILO") transaction.[220] In a typical LILO transaction, "a U.S. taxpayer leases property from a tax-exempt entity and simultaneously [sub]leases that property back to the owner."[221] For all practical purposes, a LILO transaction allows the tax-exempt property owner to continue using the property during the sublease term, just as it did before the transaction, and produces no risk of the tax-exempt owner losing control of the property.[222] The U.S. taxpayer in *BB&T* claimed that its payments made under the LILO transaction were deductible as ordinary and necessary business rental expenses under I.R.C. § 162(a)(3).[223] The *BB&T* court analyzed the validity of the characterization of the transaction as a lease under the doctrine of substance over form.[224] According to the *BB&T* court, "the parties' characterization of the form of the transaction should be respected so long as the lessor retains significant and genuine attributes of a traditional lessor."[225] The *BB&T* court re-characterized the LILO transaction under the doctrine of substance over form, holding that the transaction did not constitute a lease.[226] The court reasoned that the transaction was not a lease because the payments were circular between the two parties, with the only money actually changing hands constituting a fee or an "incentive for doing the deal."[227] The

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218. *Id.*
219. *Id.*
220. BB&T Corp. v. United States, 523 F.3d 461, 464 (4th Cir. 2008).
221. *Id.*
222. *Id.*
223. *Id.* at 471.
224. *Id.* at 472.
225. *Id.* (quoting Estate of Thomas v. Comm'r, 84 T.C. 412, 432 (1985)) (citing Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978)).
226. *Id.* at 475.
227. *Id.* at 473.

court further reasoned that possession and dominion over the property was never transferred in a manner consistent with the traditional notions of a lessor-lessee relationship.[228] The *BB&T* case illustrates how a court can apply the substance over form doctrine to re-characterize the form of a transaction (lease and subsequent sublease) as if it had not occurred at all – given that the same party controls the property in question before and after the middle formal steps are undertaken. In *BB&T*, the use of circular cash flows as an economic reality was enough to defeat the tax benefits of the transaction.

In sum, these cases stand for the proposition that differing tax consequences of a transaction with the same non-tax economic realities may render the more tax beneficial arrangement in violation of the substance over form doctrine.[229] The form of a transaction may also fail to be respected where the stated transactional form does not comport with economic realities.[230] Where the form of a transaction does not comport with economic realities, the transaction would be recast to reflect its true substance, one that makes economic sense.[231] Lastly, the form of a transaction may fail to be respected completely where parties to a transaction do not maintain genuine, significant, and traditional attributes of their stated transactional roles.[232] The potential application of the substance over form doctrine to the CIC life insurance transaction is the next section of this article.

2. Prospective Application of Doctrine to CIC Life Insurance Investment

The doctrine of substance over form is rooted in a strong public policy against circumventing the tax code by funneling transactions through conduit entities.[233] The doctrine of substance over form may be applicable to the CIC life insurance arrangement described above in Section IV.A.3, *supra*. In such an arrangement, the CIC is arguably simply a conduit entity used to purchase a life insurance policy on the CIC-funding small business owner's life. Aside from tax considerations, the end

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228. *Id.*

229. *See generally* Gregory v. Helvering, 69 F.2d 809, 810-11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

230. Rogers v. United States, 281 F.3d 1108, 1124 (10th Cir. 2002).

231. See *id.*

232. BB&T Corp. v. United States, 523 F.3d 461, 472 (4th Cir. 2008) (citing Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978)).

233. *See generally* Comm'r v. Ct. Holding Co., 324 U.S. 331, 334 (1945).

result of a CIC life insurance arrangement is simply the purchase of a life insurance contract since the ultimate economic reality is likely that payments from the life insurance contract (and the CIC) will only benefit the CIC-funding small business owner or their family.

Premiums paid for a small business owner's direct purchase of life insurance would be considered a non-deductible personal expense.[234] However, the pre-planned use of a CIC to purchase life insurance aims to make life insurance premiums paid deductible. Since the direct purchase of life insurance, and the use of a CIC to purchase life insurance result in the same non-tax economic realities, the purchase of life insurance by a CIC is the more tax beneficial arrangement, and may be in violation of the substance over form doctrine.[235]

Even if the CIC life insurance transaction form is structured to create some difference in economic reality in relation to the direct purchase of life insurance by the business owner, the new form could still fail to be respected if the CIC does not conform with genuine, significant, and traditional attributes of an insurance company.[236] As discussed previously, an insurance company would not typically purchase life insurance on its owner as an investment, and certainly not as its sole investment.[237] The failure of a CIC to act as a typical insurance company could feasibly cause the entire transactional form to be recast in accordance with economic realities, possibly as a direct purchase of life insurance by the CIC-funding small business owner.[238]

For purposes of tax analysis, it is often necessary to analyze a transaction as a whole, especially considering that most modern commercial transactions do not have a clearly defined beginning or end.[239] To that end, the substance over form doctrine has evolved over time to create another new doctrine, the step transaction doctrine (discussed below).

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234. *See generally* ZARITSKY & LEIMBERG, *supra* note 28, at 70.

235. *See generally* Gregory v. Helvering, 69 F.2d 809, 810-11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

236. *See generally* BB&T Corp. v. United States, 523 F.3d 461, 472 (4th Cir. 2008) (quoting Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978)).

237. Adkisson, *supra* note 16.

238. *See generally* Rogers v. United States, 281 F.3d 1108, 1124 (10th Cir. 2002); Adkisson, *supra* note 16.

239. D'Angelo Assocs.v. Comm'r, 70 T.C. 121, 129 (1978).

C. *Step-Transaction Doctrine*

The step transaction doctrine allows otherwise separate transactions to be considered as a single transaction for tax analysis purposes. Essentially, the step transaction doctrine prevents a taxpayer from adding additional and unnecessary steps to a transaction, which aim to lessen the tax consequences that would have been incurred without the additional steps.[240] In *Commissioner v. Court Holding Co.*, the court stated: "a sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."[241] Where the courts find that the step transaction doctrine applies, the court may disregard any steps that the court deems to be unnecessary.[242] The IRS will generally treat separate steps as a single transaction where such steps are integrated, interdependent, and focused towards a particular result.[243] The courts have looked to three basic tests in determining whether transactions are integrated, including: (1) the "binding commitment" test; (2) the "end results" test; and (3) the "mutual interdependence" test.[244]

The "binding commitment test" is the most favorable alternative for taxpayers[245] because the test has bright line rules that promote the certainty needed for effective tax planning.[246] Under the binding commitment test, a series of transactions are collapsed if there was a binding legal commitment to undertake a later transactional step at the time of entering into the earlier transaction.[247] Under the binding commitment test, taxpayer intent is not considered, only the existence of a binding legal commitment. However, the court in *King Enterprises, Inc. v. United States* court (discussed in detail below) criticized the use of the binding commitment test, stating, "the step transaction doctrine would be a dead letter if restricted to situations where the parties were bound to take certain steps."[248]

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240. *Id.*

241. Comm'r v. Ct. Holding Co., 324 U.S. 331, 334 (1945).

242. Andantech L.L.C. v. Comm'r, 331 F.3d 972, 978 (D.C. Cir. 2003).

243. Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968); Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987).

244. True v. United States, 190 F.3d 1165, 1174-75 (10th Cir. 1999).

245. King Enters., Inc. v. United States, 418 F.2d 511, 518 (Ct. Cl. 1969).

246. *Id.*

247. Comm'r v. Gordon, 391 U.S. 83, 96 (1968); United States v. Adkins-Phelps, Inc., 400 F.2d 737, 1741 (8th Cir. 1968).

248. *King Enters.*, 418 F.2d at 518.

Under the "mutual interdependence test," transactions are considered integrated if the legal relationships created by the first transaction would be meaningless or fruitless without completion of the second transaction.[249] In *King Enterprises*, all shares of C1 stock were transferred to C2, in exchange for stock in C2, cash, and notes.[250] C2 desired to diversify its holdings and stabilize its income, while C1 wished to liquidate its interests.[251] This initial sale made C1 a subsidiary of C2; however, C2 planned to immediately merge C1 into C2 following the purchase.[252] An arrangement wherein C2 purchased and then merged C1 allowed C2 to take advantage of a stepped-up basis on all of C1 assets.[253] The *King Enterprises* court stated that the stepped-up basis benefit "was considerable and probably sufficient as a justification for the merger independent of the other assigned reasons."[254] The court analyzed the arrangement under the step transaction doctrine, stating that the applicable test was whether the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.[255] The *King Enterprises* court held that since C2 received all shares of C1 in the sale, a controlling interest required to carry out a merger, the purchase constituted a step in a unified type A reorganization transaction that did not receive a stepped-up basis.[256] The court reasoned: "[i]t strains credulity . . . to believe other than that the plan to merge was something more than inchoate . . . at the time of such exchange."[257] The *King Enterprises* court further reasoned: "[i]t is difficult to believe that sophisticated businessmen arranging a multimillion dollar transaction fraught with tax potentials were so innocent of knowledge of the tax consequences as the testimony purports."[258]

Lastly, in the "end results test," a series of transactions will be integrated if there exists an intention to undertake each supposedly separate transaction in order to achieve a specific end

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249. *See* Andantech L.L.C. v. Comm'r, 331 F.3d 972, 978 (D.C. Cir. 2003); *King Enters.*, 418 F.2d at 516.

250. *King Enters.*, 418 F.2d at 514.

251. *Id.* at 518.

252. *Id.* at 518-19.

253. *Id.* at 519.

254. *Id.*

255. *Id.* at 516.

256. *Id.* at 519.

257. *Id.*

258. *Id.*

result.[259] The "end results test" is the alternative applied most often by the courts[260]; however, some courts have held that the satisfaction of any of these three tests is enough to apply the step transactions doctrine.[261]

In general, the courts analyze two factors in determining whether to apply the step transaction doctrine against the taxpayer: (1) the intent of the taxpayer,[262] and (2) the temporal proximity of the separate steps.[263] If the taxpayer has sufficient evidence to prove the taxpayer lacked the intention of carrying out a later step of the transaction, at the time of entering into the earlier step, then the transactions should not be viewed together as an integrated whole.[264] Where there is no legally binding commitment to engage in subsequent steps, the span of time between the events is the key factor in determining whether the steps should be viewed as integrated.[265] A significant lapse of time between a series of transactions should prevent the application of the step transaction doctrine.[266] Furthermore, absent a legally binding agreement,[267] a transaction should not be viewed as integrated where each step has independent economic significance.[268]

The step transactions doctrine is often used in tandem with the other judicial doctrines discussed herein, particularly the doctrine of substance over form. Where a transactional step is used to obscure the economic reality of an arrangement for the purpose of gaining more beneficial tax treatment, the step transaction doctrine may be used to compress the transaction by disregarding unnecessary transactional steps.[269] For instance, the step transaction doctrine, in tandem with the doctrine of substance over form, could eliminate, for federal income tax purposes, the use of an intermediary conduit entity that obscures the substance of an arrangement in order to garner more beneficial tax treatment.[270] Eliminating a conduit would cause

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259. *Id.* at 516 (citing DAVID R. HERWITZ, BUSINESS PLANNING, 804 (1966)).
260. Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244 (5th Cir. 1983).
261. Andantech L.L.C. v. Comm'r, 331 F.3d 972, 978 (D.C. Cir. 2003).
262. McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 523 (7th Cir. 1982).
263. *See* Cal-Maine Foods, Inc. v. Comm'r, 93 T.C. 181, 198-201 (1989).
264. *See id.* at 198-200.
265. *See id.* at 198-99.
266. *See id.* at 197-205.
267. J.E. Seagram Corp. v. Comm'r, 104 T.C. 75, 98 (1995).
268. Reef Corp. v. Comm'r, 368 F.2d 125, 134 (5th Cir. 1966).
269. *See generally* D'Angelo Assocs. v. Comm'r, 70 T.C. 121 (1978).
270. *See* Comm'r v. Ct. Holding Co., 324 U.S. 331, 334 (1945).

the arrangement to be recast in the direct transactional form,[271] which would very likely match the substance of the arrangement.

The intent of the taxpayer is the ultimate factor in determining whether to apply the step transaction doctrine.[272] Any clear evidence of a taxpayer's intent or lack thereof would trump any other factor; however, evidence of intent is often scant unless there exists a binding (likely written) agreement to carry out the later step at the time of entering the initial step.[273] For practical purposes, the amount of time between the purported steps is likely the determinative factor where there is no clear evidence of intent, or lack thereof, and where each step does not have independent economic significance.[274] Returning to the conduit entity example, it would be very unlikely for a taxpayer engaged in such a subterfuge to document the transaction with a binding agreement. However, evidence of intent could exist in written advice from the taxpayer's advisors or a transaction's promoters concerning an integrated plan.[275] Where such evidence is available, the step transaction would clearly apply in analyzing the conduit entity under the other judicial doctrines.[276] However, the amount of time between purported steps would likely be the ultimate, determinative factor where no evidence of the taxpayer's intent to carry out a later transactional step through the conduit at the time of forming the conduit entity exists.[277] The taxpayer would rely on the principle that choice of corporate form is generally respected, and argue that creation of an entity, and later transactions made by that entity hold independent economic significance.[278] However, the decision to carry out transactions within a conduit corporation was not respected for having independent economic significance in the *Mattison* and *Security Industrial* cases (discussed in the next section of this article).[279]

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271. *See generally* Andantech L.L.C. v. Comm'r, 331 F.3d 972 (D.C. Cir. 2003); *Ct. Holding Co.*, 324 U.S. at 334.

272. *See* McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 523-24 (7th Cir. 1982).

273. *See* J.E. Seagram Corp. v. Comm'r, 104 T.C. 75, 98 (1995).

274. *See* Cal-Maine Foods, Inc. v. Comm'r, 93 T.C. 181, 198-99 (1989).

275. *See id.*

276. *See McDonald's Rests. of Ill.*, 688 F.2d at 523.

277. *See generally Cal-Maine Foods*, 93 T.C. at 198-99.

278. *See* Reef Corp. v. Comm'r, 368 F.2d 125, 134 (5th Cir. 1966).

279. *See generally* Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1246 (5th Cir. 1983); United States v. Mattison, 273 F.2d 13, 17 (9th Cir. 1959).

1. Historical Doctrine Cases

The step transaction doctrine has historically been successfully applied most frequently in corporate restructuring cases. For example, in *United States. v. Mattison*, the court held that where a taxpayer who wishes to acquire a corporation's assets first purchases the stock, and then liquidates the corporation in order to acquire the assets, the step transaction doctrine applies to treat the series of steps as a single transaction.[280] Therefore, even though the acquisition occurred in the form of a stock purchase, the acquisition had the substance of an asset purchase.[281]

In *McDonald's Restaurants of Illinois*, the relationship between the parent corporation ("McDonald's") and a major nationwide franchisee ("the Garb Stern Group") began to deteriorate in 1968.[282] McDonald's considered buying some of the [Garb-Stern Group's] restaurants in Oklahoma; however, McDonald's decided not to pursue the purchase after it became clear that the purchase could not be treated as a 'pooling of interests' for accounting purposes unless all of the Garb-Stern group's restaurants were acquired simultaneously.[283] Two years later, McDonalds decided that it was necessary to make a total acquisition of all Garb-Stern franchises in order to resolve the friction between the two parties.[284] Garb-Stern agreed to a buy-out, but wanted the purchase to be tendered in cash.[285] McDonald's, on the other hand, wanted to acquire Garb-Stern's interest in exchange for McDonald's stock for tax reasons.[286] To appease both sides, a deal was negotiated whereby McDonald's would purchase Garb-Stern in stages in exchange for McDonald's stock, but Garb-Stern would be able to tender McDonald's stock to the corporation in exchange for cash within a year.[287] "The Garb-Stern [Group] was not obligated by contract to sell its McDonald's stock but fully intended to do so."[288] "In its financial statements, McDonald's treated the transaction as a 'pooling of interests.'" However, in order to get a "stepped-up" basis,

280. *Mattison*, 273 F.2d at 17.
281. *Id.*
282. McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520,521 (7th Cir. 1982).
283. *Id.*
284. *Id.* at 521-522.
285. *Id.* at 522.
286. *Id.*
287. *Id.* at 521-22.
288. *Id.* at 522.

McDonald's treated the transaction as a purchase on its annual tax return.[289]

The IRS challenged these additional basis deductions, arguing the step transactions doctrine in tandem with the doctrine of substance over form.[290] The *McDonald's Restaurants* court analyzed this transaction under the end results test, stating: "purportedly separate transactions will be amalgamated with a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[291] The Tax Court ruled that the multiple transfers of Garb-Stern assets to McDonald's were not individual taxable acquisitions, but rather they collectively consisted of a statutory merger.[292] Accordingly, McDonald's was required to take Garb-Stern's basis in the property, meaning that McDonald's was responsible for paying tax on any appreciation of the property while it was held by Garb-Stern.[293]

In *Security Industrial*, the taxpayer insurance company wished to acquire two other life insurance companies[294] by conducting an asset purchase of the other entities.[295] However, through a series of intermediary transactions, the arrangement was instead disguised as a reorganization and subsequent liquidation, in order to avoid realization of income from policyholders' surplus accounts, since realization of such income to the insurance company would be deferred under a reorganization.[296] Due to the application of the step transaction doctrine, in tandem with the doctrine of substance over form, the taxpayer's parent insurance company was required to include the amounts in acquired companies' policyholders' surplus accounts in the computation of life insurance annual taxable income of the taxpayer parent.[297]

In sum, these cases stand for the proposition that purportedly separate transactions will be amalgamated with a single transaction when it appears that they were really

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289. *Id.*

290. *Id.* at 523.

291. *Id.* at 524 (citing *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969)).

292. *Id.*

293. *Id.* at 528.

294. Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1237-38 (5th Cir. 1983).

295. *Id.*

296. *Id.* at 1236-38.

297. *Id.* at 1246.

component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[298] *Security Industrial* and *Mattison* also broadly stand for the proposition that the decision to incorporate a conduit entity, for the purpose of disguising an asset sale as a reorganization and subsequent liquidation, does not have independent economic significance.[299]

2. Prospective Application of Doctrine to CIC Life Insurance Investment

The step transactions doctrine is used in tandem with the other judicial doctrines discussed herein, particularly the doctrine of substance over form. The step transaction doctrine expands the applicability of the doctrine of substance over form by collapsing formally independent steps into a single transaction, if the steps are viewed as integrated.[300] Essentially, the step transaction doctrine may be used to disregard unnecessary transactional steps where a transactional step is used to obscure the economic reality of an arrangement for the purpose of gaining more beneficial tax treatment.[301]

Where a small business owner makes a pre-planned investment in life insurance on its owner through a CIC, the scheme involves two distinct steps. The first step involves the small business owner's funding of the CIC. The second step involves the CIC's purchase of life insurance policies on the life of the owner. The step transaction doctrine, in tandem with the doctrine of substance over form, may be applicable to the CIC life insurance arrangement discussed herein, with the goal of compressing the arrangement down to a single transaction, the purchase of non-deductible life insurance by the CIC-funding small business owner. The intent of the CIC-funding small business owner would be the determinative factor in a court's analysis of whether to compress the transaction under the step transaction doctrine.[302] If, at the time of funding the CIC, there

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298. *McDonald's Rests.*, 688 F.2d at 524 (quoting King Enters., Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969)).

299. *See generally Sec. Indus.*, 702 F.2d at 1246; United States v. Mattison, 273 F.2d 13, 17 (9th Cir. 1959).

300. Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 659 (5th Cir. 1968); Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987).

301. *See generally* D'Angelo Associates, Inc. v. Comm'r., 70 T.C. 121 (1978); *Redwing Carriers*, 399 F.2d at 655; *Penrod*, 88 T.C. at 1428.

302. *See generally D'Angelo Assocs*, 70 T.C. at 129.

exists a legally binding agreement for the CIC to purchase a life insurance policy insuring the life of the CIC-funding small business owner, there would be clear evidence of intent and the step transaction doctrine would be applicable.[303] It would be very unlikely for a taxpayer engaged in such a subterfuge to document the transaction with a binding agreement. However, evidence of intent could exist in written advice from the taxpayer's advisors concerning an integrated plan for the CIC to purchase life insurance on the taxpayer's life. Where such evidence is available, the step transaction would clearly apply in analyzing the CIC life insurance arrangement under the other judicial doctrines.[304]

If there exists no legally binding agreement or other persuasive evidence of the CIC's intent to purchase life insurance, the elapsed time between the CIC's funding and the CIC's purchase of life insurance would likely be the controlling factor.[305] The argument for integration is difficult where the elapsed time is great;[306] but some courts have viewed separate steps as a wholly integrated transaction when there exists a lapse in time of several years between the individual steps.[307] Conversely, where the elapsed time is smaller, the argument for integration is much easier.[308] A small amount of elapsed time between steps may draw IRS attention and may even be considered presumptive evidence that the funding and policy purchase should be viewed as a single transactional step — the purchase of life insurance by the CIC-funding business owner.[309]

Of course, the CIC-funding taxpayer would likely argue that the creation of a CIC has independent economic significance, since the decision to choose corporate form for carrying out transactions is generally respected.[310] However, the decision to carry out transactions within a conduit corporation has not always been respected as having independent economic significance. Just as the courts found in *Mattison* and *Security*

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303. *See generally* Comm'r v. Gordon, 391 U.S. 83, 96 (1968); United States v. Adkins-Phelps, Inc., 400 F.2d 737, 740 (8th Cir. 1968).

304. *See generally* McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 524 (7th Cir. 1982).

305. *See generally* Cal-Maine Foods, Inc. v. Comm'r, 93 T.C. 181 (1989).

306. Robert W. Wood & Dominic L. Daher, *Revisiting the Step Transaction Doctrine: The Legacy of American Bantam Car?*, 13 THE M&A TAX REPORT 3 (2004).

307. *See* May Broad. Co. v. United States, 200 F.2d 852, 857 (8th Cir. 1953).

308. Wood & Daher, *supra* note 306.

309. *See generally Cal-Maine Foods*, 93 T.C. at 218; *See* Wood & Daher, *supra* note 306.

310. Reef Corp. v. Comm'r, 368 F.2d 125 (5th Cir. 1966).

Industrial, a court could find that the decision to form a CIC corporation alone is not enough to foreclose application of the step transaction doctrine.[311] The next section of this article discusses a very broadly used doctrine for the IRS attacks on structured transactions, and the only one that has been codified – the economic substance doctrine.

D. *Economic Substance Doctrine*

The courts will generally deny claimed tax benefits related to a transaction that lacks economic substance independent of tax considerations.[312] A claimed deduction may be disallowed, under the economic substance doctrine, if the underlying transaction has no business purpose or economic effect other than the creation of tax deductions.[313] Therefore, the economic substance of a transaction shall be determined by applying an objective analysis of the transaction's actual economic consequences and a subjective analysis of the taxpayer's profit motive in entering into the transaction.[314] However, under the economic substance doctrine, objective and subjective elements are not separate prongs that must be satisfied, but are instead factors to be weighed against the transaction's purported tax benefits.[315] The primary policy behind the economic substance doctrine is that a taxpayer may not claim tax benefits that were unintended by Congress by means of a transaction that serves no economic purpose other than tax savings.[316] The issue is generally whether the transaction affects a beneficial interest and has a reasonable possibility of resulting in a profit.[317] The economic substance doctrine was codified in 2010,[318] but the IRS has provided very little guidance on how it plans on applying it.[319] In addition, the IRS has stated that it will continue to treat

311. *See* Security Industrial Ins. Co. v. United States, 702 F.2d 1234, 1245-46 (5th Cir. 1983); United States v. Mattison, 273 F.2d 13, 17 (9th Cir. 1959).

312. ACM P'ship v. Comm'r, 157 F.3d 231, 245 (3d Cir. 1998); Lerman v. Comm'r, 939 F.2d 44, 52 (3d Cir. 1991).

313. United States v. Daugerdas, 759 F. Supp. 2d 461, 466 (S.D.N.Y. 2010).

314. *ACM P'ship*, 157 F.3d at 247.

315. *Id.*

316. ACM P'ship v. Comm'r, T.C. Mem. 1997-115, at 36.

317. *Daugerdas*, 759 F. Supp. 2d at 466.

318. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-52, § 1409, 124 Stat. 1029, 1067 (codified as amended at 26 U.S.C. § 7701; I.R.C. § 7701(o) (2012).

319. *See* INTERNAL REVENUE SERVICE, GUIDANCE FOR EXAMINERS AND MANAGERS ON THE CODIFIED ECONOMIC SUBSTANCE DOCTRINE AND RELATED PENALTIES (July 15, 2011),

the economic substance doctrine case law as good law in IRS enforcement actions.[320] As a result of the absence of significant interpretational instruction on the new codified version, and the IRS continued emphasis on the existing case law, this article will only address the case law in the area of the economic substance doctrine.

1. Historical Doctrine Cases

The foundation case for several other doctrines (discussed above), *Gregory v. Helvering*, is also the seminal early case related to the economic substance doctrine.[321] The full facts of the *Gregory* case are provided above, *supra*, in section IVA.1. In *Gregory*, a parent corporation structured a tax-free reorganization of a subsidiary, in order to transfer certain assets that the parent corporation wished to sell.[322] The effect of this reorganization was to allow a tax-advantaged liquidation of the newly organized entity instead of requiring an asset sale and dividend distribution, as would have been required if the assets were sold by the prior subsidiary, since the prior subsidiary was a "going concern" because it held other assets.[323] The court held that the reorganization lacked economic substance, reasoning that dodging of shareholder's taxes is not one of the transactions contemplated under a corporate reorganization.[324]

In *Goldstein v. Commissioner*, the court held that the economic substance doctrine may apply even when a taxpayer exposes itself to risk of loss and where there is some profit potential, so long as the facts suggest that the economic risks and profit potential were insignificant when compared to the tax benefits.[325] The court reasoned that the economic substance doctrine suggests a balancing of the risks and profit potential, as compared to the tax benefits, in order to determine whether the transactions had "purpose, substance, or utility apart from their anticipated tax consequences."[326]

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available at http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties.

320. *See id.* ("The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if [the legislation] had never been enacted.").

321. Gregory v. Helvering, 69 F.2d 809, 811 (2d Cir. 1934).

322. *Id.* at 810.

323. *Id.*

324. *Id.* at 810-11.

325. Goldstein v. Comm'r, 364 F.2d 734, 739-40 (2d Cir. 1966).

326. *Id.* at 740.

In *ACM Partnership v. Commissioner*, a corporation wished to enter into a transaction that produced a capital loss to offset large amounts of capital gains previously incurred.[327] The corporation also wished to rebalance its debt portfolio by investing in the company's own debt as a part of this tax reduction strategy.[328] To accomplish these goals, the corporation entered into a partnership with a foreign bank, whereby the foreign bank was originally the majority partner.[329] The partnership purchased private placement notes and then almost immediately exchanged the private placement notes for contingent-payment installment notes that required it to recover only one-sixth of the basis in the notes in the first year.[330] The one-sixth of basis was primarily allocable to the majority partner at that time, the foreign bank.[331] After year one, the U.S. corporate partner redeemed all of the foreign bank's interest in the partnership by issuing notes.[332] At this time, the taxpayer claimed the remaining five-sixths in unrecovered basis.[333] By allocating a majority of the basis to the U.S. corporation taxpayer, the majority of the capital gain from the transaction would have been incurred by the foreign entity, not subject to U.S. federal income tax.[334] This would have the simultaneous effect of generating capital losses for the U.S. corporation taxpayer.[335]

In sum, under this arrangement, the U.S. corporation taxpayer would be allocated offsetting capital losses and the capital gains would be allocated to a foreign bank not subject to U.S. income tax.[336] The court held that the partnership transaction in *ACM* lacked economic substance since offsetting acquisitions produced only nominal, incidental effects on the U.S. corporation taxpayer's net economic position relative to the tax reduction benefits of the transaction.[337] The *ACM* court reasoned the effects to be merely nominal and incidental because the U.S. corporate taxpayer's transactions involved only:

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327. ACM P'ship v. Comm'r, 73 T.C. Mem. 1997-115, at 3-4.
328. *Id.*
329. ACM P'ship v. Comm'r, 157 F.3d 231, 237 (3d Cir. 1998).
330. *Id.* at 238.
331. *Id.*
332. *Id.* at 245.
333. *Id.*
334. *Id.* at 242.
335. *See generally id.*
336. *Id.* at 252.
337. *Id.* at 258, 260.

> [A] fleeting and economically inconsequential investment[338] in and offsetting divestment from [the notes in issue] . . . . [The U.S. corporate taxpayer] engaged in mutually offsetting transactions by acquiring [the notes at issue] only to relinquish them a short time later under circumstances which assured that their principal value would remain unchanged and their interest yield would be virtually identical to the interest yield on the cash deposits which [the U.S. corporate taxpayer] used to acquire [the notes in issue].[339]

The *ACM* court further reasoned that in order to be deductible, a loss must reflect actual economic consequences and may not result solely from creative accounting involving the generation of artificial loss through bifurcation of transactional components.[340] Furthermore, the *ACM* court held that the transaction lacked economic substance because of the lack of a subjective profit motive beyond the creation of tax deductions.[341]

In *Sala v. United States*, the taxpayer entered into an investment plan that had an initial phase specifically designed to produce losses sufficient to offset taxpayer's $60 million in income earned in the previous tax year.[342] Showing that a transaction has some profit potential is not enough to show that the transaction has economic substance.[343] The court determined that the economic substance doctrine is applied where there

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338. The *ACM* court stated,

> In the course of this brief interim investment, [the U.S. corporate taxpayer] passed $175 million of its available cash through [the notes in issue] before converting 80% of them, or $140 million, back into cash while using the remaining 20%, or $35 million, to acquire an amount of LIBOR notes that was identical, apart from transaction costs, to the amount of such notes that [the U.S. corporate taxpayer] could have acquired by investing its $35 million in cash directly into such assets. Thus, the transactions with respect to [the notes in issues] left [the U.S. corporate taxpayer] in the same position it had occupied before engaging in the offsetting acquisition and disposition of those notes. *See id.* at 250.

339. *Id.*

340. *Id.* at 252.

341. *Id.* at 253.

342. Sala v. United States, 613 F.3d 1249, 1250 (10th Cir. 2010).

343. *Id.* at 1254.

exists a "correlation of losses to tax needs coupled with a general indifference to, or absence of, economic substance."[344]

In sum, these cases stand for the following propositions. A transaction that has no profit potential other than tax benefits lacks economic substance where the chosen transactional structure is used in a Congressionally unintended manner to claim beneficial tax treatment.[345] However, even if some profit potential exists, a transaction would lack economic substance where the transaction produces only nominal, incidental effects on the taxpayer's net economic position relative to the tax reduction benefits of the transaction.[346] Thus, a transaction would be found to lack economic substance where: (1) the facts suggest that the economic risks and profit potential were insignificant when compared to the tax benefits,[347] or (2) a "correlation of losses to tax needs coupled with a general indifference to, or absence of, economic profits."[348]

2. Specific Life Insurance Cases

The economic substance doctrine has been used to challenge several life insurance transactions. In *Winn-Dixie* (full facts provided above, *supra*, in section IV.A.2), the taxpayer corporation claimed interest deduction stemming from loans taken against inside build-up in COLI plans on 36,000 employee life insurance policies.[349] Winn-Dixie funded the COLI plans by borrowing against the cash surrender values of plan policies.[350] Projections indicated that Winn-Dixie would incur a pre-tax loss on the transactions in every year of the plan's existence.[351] Projections indicated an aggregate pre-tax loss of $682 million and an aggregate after-tax gain on the transaction of $2 billion.[352] Essentially, the interest deductions claimed accounted for a $2.5 billion difference in taxable income stemming from the transaction.[353] Winn-Dixie argued that the transactions could

344. *Id.* at 1253 (citing Keeler v. Comm'r, 243 F.3d 1212, 1218 (10th Cir. 1990)).

345. *See generally* Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934).

346. *ACM P'ship*, 157 F.3d at 250, 258.

347. Goldstein v. Comm'r, 364 F.2d 734, 739 (2d Cir. 1966).

348. *Sala*, 613 F.3d at 1253 (citing *Keeler*, 243 F.3d at 1218).

349. Winn-Dixie Stores, Inc. v. Comm'r ("Winn-Dixie I"), 113 T.C. 254, 255 (1999); Winn-Dixie Stores, Inc. v. Comm'r ("Winn-Dixie II"), 254 F.3d 1313, 1314-15 (11th Cir. 2001).

350. *Winn-Dixie I*, 113 T.C. at 260 (1999).

351. *Id.* at 262.

352. *Id.* at 263.

353. *Id.* at 262-63.

produce tax-independent benefits if a catastrophe occurred which caused large amounts of unexpected death benefits to be paid out early.[354] However, the court reasoned that this eventuality was too improbable to accord it economic significance.[355] The court disallowed the interest deductions, holding that the COLI plans lacked both economic substance and business purpose other than tax reduction.[356]

In *In re CM Holdings, Inc.*, the court found that a corporate taxpayer's COLI plan lacked economic substance because the plan had no net economic effect on the corporation's financial condition, other than tax implications.[357] Furthermore, a lack of subjective economic substance was shown in this case through marketing materials, presented to corporate executives, which showed the transaction to be a wash, absent tax considerations.[358]

In sum, these cases stand for two related propositions. *Winn-Dixie* provides that a transaction may be found to lack economic substance, even where the transaction could produce substantial non-tax benefits, if the occurrence of the non-tax benefits is only under improbable circumstances,[359] *CM Holdings* provides that a transaction lacked economic substance where the taxpayer entered into the transaction with the understanding that the transaction would be a wash absent tax consideration—leaving the transaction as one with no non-tax economic effect.[360]

3. Prospective Application of Doctrine to CIC Life Insurance Investment

The economic substance doctrine is used to disallow Congressionally unintended tax benefits[361] claimed via transactions that produce only insignificant,[362] nominal, and/or incidental effects on the taxpayer's net economic position relative

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354. *Id.* at 284.

355. *Id.* at 284-85.

356. *Id.* at 285.

357. IRS v. CM Holdings, Inc. (*In re* CM Holdings, Inc.), 301 F.3d 96, 108 (3d Cir. 2002).

358. *Id.* at 103.

359. *Winn-Dixie I*, 113 T.C. at 284-85.

360. *In re CM Holdings*, 301 F.3d at 108.

361. *See* Gregory v. Helvering, 69 F.2d 809, 810-11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935); ACM P'ship v. Comm'r, 73 T.C. Mem. 1997-115, at 88-89.

362. *See* Goldstein v. Comm'r, 364 F.2d 734, 739 (2d Cir. 1966).

to the tax reduction benefits of the transaction.[363] Obviously, the economic substance doctrine would apply where a transaction has no possible economic effect other than the reduction of taxes.[364] However, in deciding whether to apply the economic substance doctrine in situations where some profit potential exists, courts weigh the objective economic consequences and subjective profit motive collectively, against the transaction's purported tax benefits.[365] A prime example of circumstances in which the courts would disallow deductions under the economic substance doctrine, even where some possible profit potential exists, is found in *CM Holdings*.[366] The *CM Holdings* court used the economic substance doctrine to disallow deductions where corporate executives entered into the transaction after being shown marketing materials that projected the transaction to likely be a wash, absent tax considerations, even though the potential for profits did remotely exist.[367]

An arrangement in which a small business owner funds a CIC for the sole purpose of purchasing life insurance on its owner would clearly violate the economic substance doctrine. This is because the creation of the CIC for the sole purpose of purchasing life insurance has no possible economic effect other than the reduction of taxes.[368] The same result could be reached, albeit in a less tax beneficial manner, where the small business owner directly purchases a life insurance policy. Therefore, the use of a CIC conduit to purchase life insurance on the CIC funder's life would exist solely for tax purposes.

However, if the CIC is funded for other legitimate insurance purposes, and only incidentally purchases life insurance on the small business owner's life, it is much more difficult to claim that this step (the creation and funding of the CIC) had no potential economic effect other than the creation of tax deductions. Where some possible non-tax profit potential exists, derived from the purchase of the life insurance inside the CIC, the objective projected non-tax economic effect and subject profit motive must be weighed against the projected tax benefits.[369] Ultimately, the economic substance doctrine may be applied where the CIC's

363. ACM P'ship v. Comm'r, 157 F.3d 231, 250 (3d Cir. 1998).
364. United States v. Daugerdas, 759 F. Supp. 2d 461, 466 (S.D.N.Y. 2010).
365. *ACM P'ship*, 157 F.3d at 247.
366. *In re CM Holdings*, 301 F.3d at 96.
367. *Id.*
368. *See generally Daugerdas*, 759 F. Supp. 2d at 466.
369. *ACM P'ship*, 157 F.3d at 247.

non-life insurance profit projections are insignificant,[370] nominal, and/or incidental in comparison to the projected tax reduction of the CIC life insurance arrangement.[371] The economic substance doctrine would almost certainly apply where evidence proves that the taxpayer subjectively understood that the CIC life insurance arrangement was an economic wash absent tax considerations.[372]

V. CONCLUSION

In general, life insurance premiums are not deductible as ordinary and necessary business expenses, and tax-deducted funds should not be used to purchase life insurance.[373] Historically, the IRS has staunchly defended against such deductions by closely monitoring and attacking arrangements intended to provide tax-deductible premiums or financing for life insurance premiums.[374] The IRS often argues that judicial tax doctrines should be applied to disallow claimed deductions on what the IRS perceives to be Congressionally unintended, life insurance oriented, abusive tax shelters.[375] The IRS is likely to view an arrangement where a small business owner funds a CIC for the primary purpose of obtaining deductions on life insurance premium payments as abusive. First, the combination of tax benefits associated with this CIC life insurance transaction may result in the funding of the insurance policy with pre-tax dollars, and the funds only being taxed once at a currently preferential 20% tax rate on the policy distribution out of the CIC.[376] Second, the life insurance policy likely only benefits the CIC-funding small business owners or their families - making the policy premiums paid arguably personal in nature.[377] Congress intended premiums paid on personal life insurance to be non-deductible and any attempt to disguise the premiums in a deductible form would likely be viewed as abusive.[378] In attacking such an arrangement, the IRS would likely utilize the following judicial doctrines: (1) the sham transaction doctrine (specifically, as a sham in substance); (2) the economic substance doctrine; (3)

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370. *See generally* Goldstein v. Comm'r, 364 F.2d 734, 739 (2d Cir. 1966).
371. *See generally ACM P'ship*, 157 F.3d at 250.
372. *See generally In re CM Holdings*, 301 F.3d at 96.
373. *See* I.R.C. § 264(a)(1) (2012); ZARITSKY & LEIMBERG, *supra* note 28, at 2-70.
374. *See generally* ZARITSKY & LEIMBERG, *supra* note 28, at 2-70.
375. *See Id.*
376. *See* Rev. Proc. 08-66, 2008-45 I.R.B. 1107.
377. *See generally* ZARITSKY & LEIMBERG, *supra* note 28; I.R.C. § 264(a)(1).
378. *See* Am. Elec. Power, Inc. v. United States, 136 F. Supp. 2d 762, 787 (S.D. Ohio 2001).

the doctrine of substance over form; and (4) the step transaction doctrine.[379]

If the IRS seeks to apply the sham transaction doctrine, it must be challenged on a sham in substance theory (as opposed to a sham in fact theory).[380] A sham in substance exists if: (1) it has no economic purposes other than tax benefits; or (2) the obligations between unrelated parties are not bona fide and genuine. [381] While the taxpayer is likely to argue that each component of the overall transaction meets the requirements for deductibility under the I.R.C., the CIC life insurance arrangement may be viewed instead as a series of transactions that collectively create an intended result that is not Congressionally intended.[382] The results of the overall arrangement are identical to the CIC funder's direct purchase of life insurance. As such, the arrangement's substance equates with a non-deductible personal life insurance purchase disguised as two separate independent legislatively approved transactions.[383] In order for the transaction as a whole to be respected as genuine, the CIC itself must operate like a real I.R.C. § 831(b) insurance company issuing real insurance.[384] A real insurance company is unlikely to purchase life insurance on an insured's owner as an investment,[385] given the purchase is primarily a personal benefit to the individual insured (among other reasons). Since the CIC life insurance transaction results in legislatively unintended tax deductible premium payments, and because of the fact that such an investment is not a transaction typically made by an independent insurance company, it is likely that the transaction as a whole creates a non-genuine obligation[386] that may be deemed a sham in substance.[387]

The substance over form doctrine states that the tax results of a transaction should be determined based on the underlying substance of the transaction, rather than upon mere tax

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379. *See generally* ADKISSON, *supra* note 16.

380. *See* Dow Chem. Co. v. United States, 278 F. Supp. 2d 844, 848 (E.D. Mich. 2003).

381. United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001).

382. *See Am. Elec. Power*, 136 F. Supp. 2d at 778.

383. *Id.* at 792.

384. *See* Adkisson, *supra* note 16.

385. *Id.*

386. *See generally* Knetsch v. United States, 364 U.S. 361, 365-66 (1960).

387. *See Am. Elec. Power*, 136 F. Supp. 2d at 778.

compliance with individual formalities along the way to the stated result.[388] While taxpayers are generally bound to the tax consequences associated with their chosen legal form, a court may still re-characterize a transaction according to its underlying substance.[389] The court will look to the objective economic realities of a transaction[390], applying the rationale that two transactions achieving the same ultimate goal should not garner different tax treatment simply because the transactions follow different formal steps along the way.[391] Premiums paid for a small business owner's direct purchase of life insurance would be considered a non-deductible personal expense.[392] The pre-planned use of a CIC to purchase the same life insurance seeks to make the premiums paid deductible. Since the direct purchase of life insurance and the pre-planned use of a CIC to purchase life insurance result in the same non-tax economic realities, the purchase of life insurance by a CIC is the more tax beneficial arrangement, and may be in violation of the substance over form doctrine.[393] The failure of a CIC to act as a typical insurance company could feasibly cause the entire transactional form to be recast in accordance with economic realities, possibly as a direct purchase of life insurance by the CIC-funding small business owner.[394]

The step transaction doctrine allows otherwise separate transactions to be considered as a single transaction for tax analysis purposes, preventing the addition of unnecessary transaction steps to create improper tax benefits otherwise unattainable without the new steps.[395] The court may treat separate steps as a single transaction where such steps are integrated, interdependent, and focused towards a particular result,[396] then disregard any steps that the court deems to be unnecessary[397]. The IRS will generally analyze two factors in

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388. *See* Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

389. Comm'r v. Danielson, 378 F.2d 771 (3d Cir. 1967).

390. Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978).

391. *Minn. Tea Co.*, 302 U.S. at 613.

392. *See generally* ZARITSKY & LEIMBERG, *supra* note 28.

393. *See* Gregory v. Helvering, 69 F.2d 809, 810-11 (2d Cir. 1934) (explaining that "a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or if one choose, to evade, taxation").

394. *See generally* Rogers v. United States, 281 F.3d 1108, 1124 (10th Cir. 2002); Adkisson, *supra* note 16.

395. D'Angelo Assoc. v. Comm'r., 70 T.C. 121, 129-31 (1978).

396. *See* Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968); Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987).

397. Andantech L.L.C. v. Comm'r, 331 F.3d 972 (D.C. Cir. 2003).

determining whether to apply the step transaction doctrine against the taxpayer: (1) the intent of the taxpayer,[398] and (2) the temporal proximity of the separate steps.[399] Where a small business owner makes a pre-planned investment in life insurance through a CIC, the scheme involves two distinct steps: (a) the small business owner's funding of the CIC and (b) the CIC's purchase of life insurance policies on the life of the owner. The step transaction doctrine may operate in tandem with substance over form doctrine to compress the arrangement down to a single transaction, —the purchase of non-deductible life insurance by the CIC-funding small business owner. The intent of the CIC-funding small business owner would be the determinative factor in a court's analysis of whether to compress the transaction. If, at the time of funding the CIC, a legally binding agreement exists for the CIC to purchase the life insurance policy, this would establish intent and the step transaction doctrine applies.[400] If there is no legally binding agreement, or other persuasive evidence of the CIC's intent to purchase the life insurance, the elapsed time between the CIC's funding and the CIC's purchase of life insurance would likely be the controlling factor.[401] The argument for integration is more difficult if the elapsed time is great and integration is easier if the elapsed time is short.[402] A significantly short elapsed time between steps likely provides presumptive evidence that the separate steps are really one transaction - the direct purchase of life insurance by the CIC-funding business owner.

The courts will generally deny claimed tax benefits related to a transaction that lacks economic substance independent of tax considerations.[403] Thus, a claimed deduction may be disallowed, if the underlying transaction has no business purpose or economic effect other than the creation of tax deductions.[404] Therefore, the economic substance of a transaction may be determined by application of an objective analysis of the transaction's actual economic consequences and a subjective analysis of the taxpayer's profit motive in entering into the

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398. *See, e.g.*, McDonald's Rest. of Ill., Inc. v. Comm'r, 688 F.2d 520, 523 (7th Cir. 1982).

399. *See* Cal-Maine Foods, Inc. v. Comm'r, 93 T.C. 181, 198-99 (1989).

400. *See generally* Gordon v. Comm'r, 391 U.S. 83, 96 (1968); United States v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968).

401. *See* Redding v. Comm'r, 630 F.2d 1169, 1178 (7th Cir. 1980)

402. Wood & Daher, *supra* note 306.

403. ACM P'ship v. Comm'r, 157 F.3d 231, 245 (3d Cir. 1998); Lerman v. Comm'r, 939 F.2d 44, 52 (3d Cir. 1991).

404. United States v. Daugerdas, 759 F. Supp. 2d 461, 466 (S.D.N.Y. 2010).

transaction.[405] These objective and subjective elements are not separate prongs, but rather are factors weighed against the transaction's purported tax benefits.[406] The primary policy behind the economic substance doctrine is that a taxpayer may not claim tax benefits that were unintended by Congress by means of a transaction that serves no economic purpose other than tax savings.[407] The issue is generally whether the transaction affects a beneficial interest and has a reasonable possibility of resulting in a profit.[408] An arrangement in which a small business owner funds a CIC for the sole purpose of purchasing life insurance would violate the economic substance doctrine, because the creation of the CIC would have no subjective economic effect beyond the reduction of taxes.[409] If the CIC is created and funded for legitimate insurance purposes, and only incidentally purchases life insurance on the small business owner's life, it is obviously much more difficult to make the "sole purpose" argument.[410] Where some possible non-tax profit potential exists derived from the purchase of the life insurance inside the CIC, the objective projected non-tax economic effect and subject profit motive must be weighed against the projected tax benefits.[411] Ultimately, the economic substance doctrine likely applies if (1) the CIC's non-life insurance profit projections are insignificant,[412] nominal, and/or incidental in comparison to the projected tax reduction of the CIC life insurance arrangement,[413] or (2) evidence proves that the taxpayer subjectively understood that the overall transaction was an economic wash absent the tax benefits.[414]

In sum, the IRS has several judicial doctrines available at its disposal to attack taxpayers seeking to use a CIC as a conduit for deducting life insurance premiums. Many of these judicial doctrines overlap and work together in tandem to disallow the improper tax benefits of a transaction. Of course, the facts and circumstances of the actual CIC life insurance transaction often

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405. *ACM P'ship*, 157 F.3d at 247.

406. *Id.*

407. ACM P'ship v. Comm'r, T.C. Mem. 1997-115, at 36.

408. *Daugerdas*, 759 F. Supp. 2d at 466.

409. *See generally id.* (holding that the "indictment was not deficient merely because it alleged that the tax shelters provided no reasonable possibility of profit").

410. United States v. Fleming, 9 F.3d 1325, 1339 (10th Cir. 1994).

411. *ACM P'ship*, 157 F.3d at 247.

412. *See generally* Goldstein v. Comm'r, 364 F.2d 734, 739 (2d Cir. 1966).

413. *See ACM P'ship*, 157 F.3d at 250.

414. *See* IRS v. CM Holdings, Inc. (*In re* CM Holdings), Inc., 301 F.3d 96, 106 (3d Cir. 2002).

will dictate whether there is enough substance for the IRS to succeed in applying any or all of these judicial doctrines. In the end, the IRS likely will apply each of the above doctrines as enforcement mechanisms to force these members of the life insurance community to relearn an important lesson: using tax vehicles to create tax deductible life insurance premiums does not end well for anyone involved.