REPEAT AS NECESSARY: HISTORICAL IRS POLICY WEAPONS TO COMBAT CONDUIT CAPTIVE INSURANCE COMPANY DEDUCTIBLE PURCHASES OF LIFE INSURANCE

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ABSTRACT

The life insurance community has a long and tortured history of seeking the Holy Grail of insurance schemes: the tax-deductible life insurance premium. Nearly every year around tax planning season, life insurance agents attempt to boost year-end sales by offering some kind of tax-deductible premium plan — the newest of which is the small business Captive Insurance Company ("CIC") as an investor in life insurance. In this transaction, a small business deducts premium payments for business risks to an IRC § 831(b) CIC; the CIC is permitted to receive up to $1.2 million of premium income tax-free; and the CIC uses a substantial amount of the tax-free premium immediately to purchase life insurance on the small business owners who often also own the CIC. The Internal Revenue Service ("IRS") already loses a substantial amount of otherwise collectible tax revenue due to the existing tax-breaks afforded life insurance policyholders, such as tax-free internal build-up inside life insurance policies and the receipt of policy proceeds tax-free at the death of the insured. Therefore, the IRS has historically staunchly defended the loss of additional life insurance-oriented tax revenue that may derive from tax-deductible life insurance premiums. In furtherance of this defense, the IRS has brought cases against individual taxpayers and promoters, designated certain abusive life insurance arrangements as listed transactions, and imposed accuracy-related taxpayer penalties.

The IRS is likely to view an arrangement where a small business owner funds a CIC for the primary purpose of obtaining deductions on owner-insider life insurance premium payments as similarly abusive to prior listed transactions involving I.R.C. § 419 plans, I.R.C. § 412(e)(3) plans, and I.R.C. § 831(b)

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Producer Owned Reinsurance Companies ("PORCs"). They will also likely view this as a violation of its historical tax enforcement policies against discriminatory insider tax benefits and improper uses of key man life insurance. The IRS should view the use of an entity as a direct conduit for achieving an impermissible tax-deductible premium payment in the same manner as it would the taxpayer taking the deduction directly. This article discusses (I) the history of using taxation as a motivation for sales in the life insurance business, (II) the IRS enforcement and tax policy in combating improper tax uses of life insurance, and (III) evaluates the likely success of applying these historical arguments to establish that insider life insurance premiums are not deductible, nor should any tax-deducted funds be used to purchase such policies.

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

Life insurance is an extremely 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 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. 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.[1]

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.[2] Furthermore, the I.R.C. allows

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[1] I.R.S. Tech. Adv. Mem. 200213010 (Mar. 29, 2002), *available at* 2002 WL 481259.
[2] I.R.C. § 101(a) (2006).

for tax-free internal build-up on the investment accounts for certain permanent life insurance policies.[3] This tax-free internal build-up is essentially a retirement account with investments growing untaxed until retirement.[4] Congress has allowed the investment gain from the internal build-up to be deferred until the policy is cashed-out and completely excluded from income if the policy is held until the death of the insured.[5] Since Congress has already granted these valuable subsidies to the life insurance industry to the significant detriment of the IRS' collectible revenue, the IRS is very skeptical of any attempt by the life insurance industry to garner additional legislatively unintended tax benefits.[6]

Historically, life insurance companies and life insurance agents have made substantial life insurance sales by selling policies for estate planning purposes. The life insurance proceeds can be used to pay the US Federal Estate Taxes ("Estate Tax")[7] due at death on the transfer of the fair market value of estate assets,[8] especially where significant assets are illiquid (such as a family business).[9] However, given that over time the amount of assets that can be transferred free of Estate Tax has risen steadily over the last decade,[10] the need for life insurance in estate planning has been significantly reduced.[11] To make up for these reduced life insurance sales, the life insurance industry has continually attempted to provide new reasons for consumers to purchase life insurance, including several programs that make use of income tax incentives.

The life insurance industry has 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. These

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3 I.R.S. Tech. Adv. Mem. 200213010, *supra* note 1.

4 *See generally id.* (stating that internal buildup of investment income within whole life policies may enjoy tax deferral until withdrawal, thereby having similarities to a retirement account that avoids tax until withdrawal).

5 *See* DAVID L. BRUMBAUGH, CONG. RESEARCH SERV., RS20923, TAXES AND THE "INSIDE BUILD-UP" OF LIFE INSURANCE: RECENT ISSUES, 1 (Aug. 2, 2006), *available at* 2006 WL 4596553.

6 *See* I.R.S. Tech. Adv. Mem. 200213010, *supra* note 1.

7 *See* I.R.C. § 2001.

8 MARSHA GOETTING, MONT. STATE UNIV., BOZEMAN EXTENSION, LIFE INSURANCE: AN ESTATE PLANNING TOOL (Jan. 2009), *available at* http://msuextension.org/publications/FamilyFinancialManagement/MT199211HR.pdf.

9 *Id.*

10 *See* I.R.C. §§ 2010(c)(3)-(4) ($5 million individually, $10 million for a couple in 2012).

11 *See generally* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (June 7, 2001) (with the estate tax completely repealed in 2010, and the exclusion amount having steadily risen to an all-time high of $5.12 million thereafter, the need for estate planning has lessened, in general, and therefore the need for life insurance, which has long enjoyed the benefits of high demand for meeting the needs of an illiquid estate's transfer tax obligations, has now been reduced).

arrangements have included I.R.C. § 419 plans,[12] I.R.C. § 412(e)(3) plans,[13] Company Owned Life Insurance ("COLI") plans,[14] and I.R.C. § 831(b) Producer Owned Reinsurance Companies ("PORCs").[15] However, in most of these arrangements, the IRS has quickly closed the tax loopholes by designating these transactions as "listed transactions,"[16] and in each of them the IRS has undertaken strong enforcement measures against the transaction. The end result for taxpayer participants in such arrangements has been expensive litigation, generally unfavorable results, and even accuracy-related taxpayer penalties.[17]

The life insurance industry's latest attempt to provide an income tax incentive for the purchase of life insurance has been the creation of a captive insurance companies ("CIC") by small business owners (ostensibly for insuring business risks), and having the CIC invest in life insurance on the CIC/business owner's life.[18] 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.[19] An ordinary and necessary business expense is tax

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12 *See, e.g.*, Neonatology Associates, P.A. v. Comm'r, 115 T.C. 43 (2000) (wherein a scheme was devised to garner impermissible tax deductible life insurance premiums by artificially inflating the amount of life insurance premiums deductible for what was claimed to be permissible key man term life insurance coverage, when in fact it was not simple term life insurance coverage since there existed an investment component to the transaction).

13 *See generally* Sherwin P. Simmons & Stephan R. Leimberg, *Prop. Regs. Address Abusive Transactions Involving Life Insurance in Qualified Plans*, 31 ESTPLN 163 (2004) (discussing new IRS guidance intended to eliminate abusive transaction involving I.R.C. § 412(e)(3) plans and "attempts to use policy design and contractual provisions to (1) under report the value of life insurance policies distributed or sold from a qualified retirement plan, (2) increase an employer's front-end tax deductions, or (3) provide bloated and discriminatory benefits to highly compensated plan participants, particularly owner-employees and other members of the prohibited group").

14 *See, e.g.*, Winn-Dixie, Inc. v. Comm'r, 113 T.C. 254 (1999) (holding that interest, paid by employer on policy loans taken against life insurance policies covering lives of its employees, was incurred as part of sham transaction engaged in to attempt to garner impermissible tax-deductible financing of life insurance premiums, and thus was not deductible).

15 *See generally* William P. Elliott, *A Guide to Captive Insurance Companies (Part 3) – IRS Proactivity in Captive Taxation*, 16 JITAX 34, 41 (2005) (discussing the impermissibility of schemes using PORCs to produce deductible premiums in the context of a consumer lender selling credit life insurance.

16 *See* Rev. Rul. 2004-20, 2004-1 C.B. 546, *available at* 2004 WL 259195; Rev. Rul. 2004-21, 2004-1 C.B. 544, *available at* 2004 WL 259196; I.R.S. Notice 2002-70, 2002-2 C.B. 765.

17 *See* I.R.S. Ann. 2002-96, 2002-2 C.B. 756, *available at* 2002 WL 31267396 (2002); Neonatology Assocs., P.A. v. Comm'r, 115 T.C. 43, 51 (2000); Neonatology Assocs., P.A. v. Comm'r, 299 F.3d 221, 223 (3rd Cir. 2002).

18 *See* Jay Adkisson, *Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance*, RISSER ADKISSON LLP, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm [hereinafter *Bad Financial Medicine*].

19 *See* I.R.C. § 162(a).

deductible, so the CIC premiums are made tax-free.[20] In the context of an I.R.C. § 831(b) CIC,[21] such business-risk insurance premiums may be deductible up to $1.2 million per year, and these premiums are also not included in the taxable income of the CIC.[22] Theoretically, the CIC could then purchase life insurance on the small business owner's life with pre-tax dollars as an investment.[23] Although these separate steps each meet the formalities of the I.R.C., the IRS may still attack these arrangements as against the public policy behind the individual Congressionally mandated tax subsidies comprising the whole arrangement.

Congress intended that premiums paid on personal life insurance be non-deductible.[24] Life insurance 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 owners and their families. The IRS has a long history of successfully attacking life insurance arrangements that alter the form of transactions for the purpose of garnering tax benefits, and small business owners would be wise to take notice of the inherent risks involved with participation in such an arrangement. Part II of this article discusses: (A) the IRS general policy against tax-deductible life insurance premiums; (B) IRS enforcement actions against specific insurance-oriented tax vehicles and the IRS tax policies that grew out of these challenges; and (C) the Congressionally created tax benefits of life insurance. Part III discusses (A) the current attempted use of an I.R.C. § 831(b) CIC as a tax vehicle to create tax-deductible life insurance premiums ("Insurance Transaction"); and (B) how the IRS may challenge the Insurance Transaction, tying in the tax policies formed in prior tax-oriented insurance vehicle enforcement actions.

I. 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.[25] The United States government has staunchly defended this position through Congressional action[26] and a series of United States Tax Court ("USTC") cases[27] brought by the IRS. The IRS has also made announcements of intent to "vigorously" pursue taxpayers who claim invalid

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[20] *Id.*; Adkisson, *supra* note 18.
[21] I.R.C. § 831(b).
[22] *See id.*
[23] Adkisson, *supra* note 18.
[24] Howard Zaritsky & Stephan Leimberg, *Deductibility of Life Insurance Premiums*, *in* Tax Planning with Life Insurance: Analysis with Forms § 2.08 (2011).
[25] *Id.*
[26] *See* I.R.C. § 264.
[27] *See* Giannaris v. Comm'r, No. 21098–08S. (T.C. 2009), *available at* 2009 WL 2176609, 2.

ordinary business expense deductions associated with the purchase of life insurance.[28] The IRS has declared that it will impose accuracy-related taxpayer penalties as a deterrence mechanism on taxpayers in appropriate cases.[29] The taxpayer ultimately bears the burden of proving that a claimed expense or loss is deductible.[30] The following section of this article discusses specific statutory and case law expressions of this policy of non-deductibility.

A. General Tax Policy Relating to Life Insurance Non-Deductibility

Section 264(a)(1) of the I.R.C. provides that, in general, premiums on any life insurance policy are non-deductible if the taxpayer is directly or indirectly a beneficiary under the policy.[31] Section 264(a)(2) further provides that interest on policy loans or other indebtedness with respect to life insurance is generally non-deductible.[32] Section 264(f)(1) states that "no deduction shall be allowed for that portion of the taxpayer's"[33] [loan] interest expense which is allocable to "un-borrowed policy cash values."[34] Un-borrowed policy cash values are the excess of the cash surrender value of the life insurance policy over the amount of any loan made with respect to the life insurance policy.[35] Congress has made an exception to the general rule by allowing business owners to deduct a limited amount of interest on borrowed funds used to pay premiums on key man life insurance policies.[36] However, in *Giannaris v. C.I.R.*[37] the IRS successfully challenged the deductibility of interest expense on loans taken out against existing life insurance

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[28] I.R.S. Ann. 2002-96, *supra* note 17.

[29] *See, e.g.*, *Neonatology Assocs.*,115 T.C. at 97-98 (holding that the IRS's imposition of a 20% accuracy-related penalty is appropriate for any underpayment that is due to the taxpayer's negligence or disregard of the rules).

[30] Am. Elec. Power, Inc. v. U.S., 136 F. Supp. 2d 726, 778 (S.D. Ohio 2001).

[31] I.R.C. § 264(a)(1).

[32] I.R.C. § 264(a)(2).

[33] *See* I.R.C. § 264(f)(8)(B) (omitting an insurance company taxpayer subject to Internal Revenue Code Subchapter L.).

[34] I.R.C. § 264(f)(1).

[35] I.R.C. § 264(f)(3).

[36] Congress has made an provided an exception to the general rule of non-deductibility of *loan interest* on life insurance purchased on the life of a key person of a business ("key man life insurance"). I.R.C. § 264(e)(1) states that up to $50,000 of loan interest incurred on key person life insurance may be deductible so long as the expenditure otherwise meets the definition of a necessary and ordinary business expense under I.R.C. § 162(a). Furthermore, I.R.C. § 264(f)(4) offers an exception to the general rule that interest incurred on un-borrowed policy cash value is non-deductible for key man life insurance loans. I.R.C. § 264(f)(4) states that the limitation on the deductibility of interest incurred on un-borrowed policy cash value shall not apply to any key man life insurance policy owned by an entity engaged in a trade or business, so long as such policy covers only one key man individual (or the joint lives of one key man individual and such key man individual's spouse).

[37] *Giannaris*, 2009 WL 2176609.

policies.[38] Next, this article discusses specific tax vehicles, successfully combated by the IRS, specifically involving the tax-deductible or tax-advantaged payment of life insurance premiums.

B. IRS Enforcement Against Specific Tax Vehicles

The IRS has a long history of going to war with promoters and taxpayer participants of vehicles that result in tax-deductible or tax-advantaged life insurance premium payments. Some of these vehicles are discussed below, including: (1) I.R.C. § 419 Plans; (2) I.R.C. § 412(e)(3) Plans; (3) COLI Financing Arrangements; and (4) the PORC Listed Transaction.

1. I.R.C. § 419 Plans

Plans created under I.R.C. § 419 involve contributions paid or accrued by an employer to a "welfare benefit fund."[39] A welfare benefit fund means any fund: (i) that is not taxed under I.R.C. §§ 83(h), 404, or 404A;[40] (ii) that is organized as a trust, corporation, or organization not exempt from income tax;[41] (iii) that is part of an employer's plan;[42] and (iv) through which the employer provides welfare benefits to employees or their beneficiaries.[43] However, welfare benefit fund status would not be accorded to a plan in which the employer allows funds to be held by an insurance company pursuant to a life insurance contract found to be non-deductible under I.R.C. § 264(a) (*i.e.*, a life insurance policy where an employer is either a direct or indirect beneficiary, other than key man life insurance).[44] Welfare benefit funds commonly take the form of Voluntary Employees' Benefit Associations ("VEBA") or trusts.[45] These plans provide certain types of benefits for employees, including: life insurance, disability insurance, health insurance, supplemental unemployment compensation, severance pay, long-term care, and post-retirement medical.[46]

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[38] In *Giannaris*, the taxpayers borrowed cash against a whole life insurance policy, accruing interest expense on the indebtedness. When the indebtedness reached the value of the death benefit, the insurance company terminated the policy pursuant to the contract. The IRS determined that there was reportable income to taxpayers upon termination of the policy, and the taxpayer claimed deductions in interest expense. The USTC held that the taxpayer's interest expense was non-deductible personal interest.

[39] I.R.C. § 419(a).

[40] I.R.C. § 419(e)(2).

[41] I.R.C. § 419(e)(3)(B).

[42] *See* I.R.C. § 419(e)(1).

[43] *See* I.R.C. § 419(e)(1).

[44] *See* I.R.C. § 419(e)(4)(A)(i).

[45] *See generally Neonatology Assocs.*, 115 T.C. 43, 44-45 (wherein the IRS challenged various VEBA plans that related to other various purported welfare benefit trusts).

[46] Investopedia.com, *419(e) Welfare Benefit Plans*, *available at* http://www.investopedia.com/terms/s/ section419ewelfarebenefitplan.asp#axzz1z2Rr5MhV; *see* I.R.C. § 419A.

Contributions to welfare benefit funds are not explicitly deductible under I.R.C. § 419. However, I.R.C. § 419 does authorize tax deductibility for welfare benefit fund contributions, provided the contributions would otherwise be considered tax deductible under the I.R.C.[47] Despite the legitimate benefits of I.R.C. § 419(e) plans, the deductibility authorized under I.R.C. § 419(a) has been rampant with abuse, with the IRS imposing penalties to deter fringe activity in what the IRS perceives to be a ripe area for marketed tax shelters.[48] Two of the milestone cases in this area are described below to provide an example of successful I.R.C. § 419 litigation cases.

a. Neonatology Associates, P.A. v. Commissioner

In 2000, the IRS litigated and won a major USTC battle against abusive I.R.C. § 419(e) VEBA plans in *Neonatology Associates, P.A. v. Commissioner*.[49] In *Neonatology*, three similar test cases were combined, and litigants in nineteen additional cases agreed to be bound by the court's decision.[50] The contributions under the *Neonatology* plans were used to purchase an innovative life insurance product known as the continuous group ("C-group") product.[51] The C-group product was designed to masquerade as a policy that provided only term life insurance benefits in order to make the product marketable to targeted investors and to make life insurance purchases from it relatively more attractive than from competing products.[52] In actuality, the C-group product, prevalent in *Neonatology*, is a universal life product consisting of two related policies.[53] The first policy is a group term life insurance policy covering key man employees while they work, maintained during the accumulation phase of the C-group product.[54] The second policy is an individual universal life insurance policy converted from the group term life policy and maintained during the payout phase of the C-group product.[55] During the payout phase in *Neonatology*, policy loans could be taken at nearly no cost to a policyholder with substantial conversion credits — i.e., a wash loan.[56] The premiums in the *Neonatology* 419(e) plans were found to be four to six times higher than they would be under a conventional group term life insurance plan.[57] Further, once the plans were converted during

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47 I.R.C. §§ 419(a)(1)-(2).
48 *See Neonatology Assocs.*, 115 T.C. at 97-8.
49 *Id.* at 93-4.
50 *Id.* at 44-5.
51 *Id.* at 53.
52 *Id.*
53 *Id.*
54 *Id.*
55 *Id.*
56 *Id.* at 53-4.
57 *Id.* at 54.

the payout phase, the employee had no premiums due because the plan was already fully funded.[58]

The USTC, in *Neonatology*, held that contributions made by an employer to a VEBA plan in excess of the cost of term life insurance were taxable constructive dividends to the owner-employee, rather than employer deductible expenses.[59] The Tax Court reasoned that employer taxpayers should not be allowed to claim deductions for contributions in excess of the amount used to fund the term life insurance.[60] The USTC stated that these additional contribution amounts were not ordinary and necessary business expenses under I.R.C. § 162 and that, while the form of these plans complied with I.R.C. § 419, the substance of these plans did not.[61] Therefore, the USTC disallowed the deductions for premiums allocable to the universal life insurance portions of the C-group policies and taxed such premiums as constructive dividends to the owner-employees. The Third Circuit affirmed the USTC *Neonatology* decision, stating that "an examination of the record convinces us that the contributions at the heart of this dispute were so far in excess of the cost of annual life insurance protection that they could not plausibly qualify as ordinary and necessary business expenses in accordance with I.R.C. § 162."[62]

The IRS subsequently made certain types of 419 plans listed transactions in IRS Notice 2003-24.[63] Presumably, this would have stopped promoters from continuing to offer 419 plans to potential taxpayers as a method of aggressively deducting life insurance premiums. Of course, certain promoters did not let negative case law or a listed transaction notice deter them, as described in the next section of this article.

b. The Benistar 419 Plan

The USTC case of *Curcio v. Commissioner* consolidated three groups of test cases relating to an I.R.C. § 419(e) plan known as the "Benistar 419 Plan".[64] The Benistar 419 Plan was crafted as a multiple employer welfare benefit trust under I.R.C. § 419A(f)(6), providing pre-retirement life insurance to select covered employees of employers enrolled in the plan.[65] The benefits of Benistar 419 Plan enrollment were marketed as: (i) virtually unlimited deductions for the employer; (ii) selective coverage to key employees; (iii) tax-free accumulation of funds accumulated inside the Benistar 419 Plan; (iv) tax-free receipt of death

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[58] *Id.*
[59] *Id.* at 91; *see also Neonatology Assocs.*, 299 F.3d at 223.
[60] *Neonatology Assocs.*, 115 T.C. at 45.
[61] *Id.* at 88-90.
[62] *Neonatology Assocs*., 299 F.3d at 223.
[63] I.R.S. Notice 2003-24, 2003-18 I.R.B. 853 (2003).
[64] Curcio v. Comm'r, T.C.M. 2010-115, 1 (2010).
[65] *Id.* at 2.

benefits received under the Benistar 419 Plan; and (v) creditor protection for funds inside the Benistar 419 Plan.[66]

The Benistar 419 Plan had three major phases. First, the enrolled employers contributed money to a trust account used for purchasing life insurance and funding the Benistar 419 Plan.[67] In return, the Benistar 419 Plan issued certificates of coverage to the employers for the amount of the death benefits payable by the plan.[68] Secondly, Benistar used the contributions to acquire and pay premiums on life insurance policies covering the employees insured by the plan.[69] Lastly, the employee would purchase the policy within the plan at minimal cost.[70] The employee would pay a 10 percent fee to Benistar to buy the policy, but the fee was based on the previous year's net surrender value rather than the actual fair market value of the policy.[71]

The covered employees and/or the enrolled employer exercised a large degree of control over the terms of the policies, such as selecting: the carrier, the benefit amount, the premium payment terms, and the type of insurance[72] — term, whole, universal, or variable.[73] Because whole life insurance, universal life insurance, and variable life insurance all include a savings component in addition to an insurance component, these types of policies almost always have higher premiums than term life insurance.[74] Whole life, universal life, and variable life also typically accumulate value that may be removed from the policy either via a loan from the insurance company secured by the policy or a cash withdrawal that reduces the savings component of the policy.[75] However, during the period in which Benistar owned the policies, Benistar did not permit enrolled employers or covered employees to withdraw money from their underlying policies through either loans or cash withdrawals.[76] Instead, during the time in which Benistar owned the underlying policy, anything paid out by the underlying policy was

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[66] *Id.* at 5.
[67] *Id.* at 2.
[68] *Id.* at 2, 19.
[69] *Id.* at 2.
[70] *Id.* at 19.
[71] *Id.*
[72] Term life insurance covers the insured only for a particular period, and upon expiration of that period, terminates without value. Whole life insurance covers an insured for life, during which the insured pays fixed premiums, accumulates savings from an invested portion of the premiums, and receives a guaranteed benefit upon death, to be paid to a named beneficiary. Universal life insurance is term life insurance in which the premiums are paid from the insured's earnings from a money-market fund. Variable life insurance is life insurance in which the premiums are invested in securities and whose death benefits thus depend on the securities' performance, though there is a minimum guaranteed death benefit. *See Curcio*, T.C.M. 2010-115 at 3.
[73] *Curcio*, T.C.M. 2010-115 at 3.
[74] *Id.*
[75] *Id.*
[76] *Id.*

required to be reinvested in the underlying policy as a paid-up addition.[77] Paid-up additions had the effect of increasing the death benefit of the underlying policy, but paid-up additions did not affect the death benefit promised by Benistar to the covered employee or enrolled employer.[78]

Prospective participants selecting a variable universal life insurance policy were required to allocate the investment portion of the policy to either the insurance guaranteed fund or the Standard & Poor's (S & P) 500 equity index.[79] The purpose of this restriction was to ensure that participants did not use the underlying insurance policy as a means of accumulating assets.[80] The Benistar 419 Plan's original stated policy was to terminate covered employees that used the plan to accumulate assets.[81]

In *Curcio*, the USTC upheld the deficiencies and penalties imposed by the IRS, holding that the contributions made by the participating companies were not ordinary and necessary business expenses deductible under I.R.C. § 162.[82] The USTC stated that the Benistar 419 Plan was a "thinly disguised vehicle for unlimited tax deductible investments"[83] and that the amounts paid under the Plan were "essentially distributions of corporate profits."[84] The USTC reasoned that it was improper for the enrolled employers to use the Benistar 419 Plan to funnel pre-tax business profits into cash-laden life insurance policies over which they retained effective control (particularly following the employee or employers purchase of the policy).[85] The USTC further reasoned that, in practice, companies could easily abuse such arrangements since the board of directors could determine which employees should be covered. Ultimately, the board of directors could choose to benefit its members by disguising dividends as deductible company expense through the Benistar 419 Plan.

In *Curcio*, the IRS was once again successful in defending the non-deductibility of certain investment-oriented life insurance arrangements. However, the life insurance community did not learn its lesson with the negative results encountered with deducting insurance premiums under I.R.C. § 419. They subsequently moved on to I.R.C. § 412(e)(3) plans to take another shot at aggressive tax-avoidant funding of life insurance.

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[77] *Id.* at 4.
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.* at 13.
[83] *Id.* at 20.
[84] *Id.* at 22.
[85] *Id.* at 13.

2. I.R.C. § 412(e)(3) Plans

a. In General

I.R.C. § 412(e)(3)[86] plans offer another avenue for companies to provide life insurance for employees.[87] As with other plans involving life insurance, I.R.C. § 412(e)(3) plans have been abused by companies for improper tax benefits.[88] I.R.C. § 412(e)(3) plans were a target for abuse because these plans were not subject to the normal statutory funding and accrual requirements of other qualified plans.[89]

b. I.R.C. § 412(e)(3) Plan Requirements

An I.R.C. § 412(e)(3) plan is a type of defined benefit plan. For a defined benefit plan to be considered qualified, the plan must: (i) be permanent; (ii) provide defined benefits in the form of a retirement or a deferred compensation plan; and (iii) be for the exclusive benefit of employees or their beneficiaries.[90] Additionally, qualified plans should not discriminate in favor of highly compensated employees.[91]

The relaxed minimum funding and accrual requirements are not accorded to all defined benefit plans — only those that meet the requirements of I.R.C. § 412(e)(3). A valid I.R.C. § 412(e)(3) plan typically consists of the following general steps: (i) an employer establishes a trust to hold the plan's assets; and (ii) the trust uses tax-deductible employer contributions to purchase and maintain life insurance for the plan.[92] I.R.C. § 412(e)(3) specifically requires that: (a) the plan be funded exclusively by the purchase of individual insurance (e.g., annuities or life insurance contracts from an insurance company);[93] (b) the premium payments be level and payable for a period not extending beyond the retirement age for each individual participant;[94] (c) the benefits under the plan be equal to the benefits provided under the individual contract at "normal retirement age;"[95] (d) the benefits for each individual under the plan be guaranteed by the insurance carrier at least to the extent premiums have been paid;[96] (e) before any lapse, all

[86] I.R.C. § 412(e)(3) (original version at I.R.C. § 412(i) (YEAR)); *see also* Treas. Reg. § 1.412(i)-1 (2012).
[87] *See* Simmons & Leimberg, *supra* note 13 at 164.
[88] *See id.* at 163-165, 168.
[89] I.R.C. § 412(a)(1); I.R.C. § (e)(3); Simmons & Leimberg, *supra* note 13.
[90] Simmons & Leimberg, *supra* note 13.
[91] *Id.*
[92] Zarella v. Pac. Life Ins. Co., 755 F.Supp. 2d 1218 (S.D. Fla. 2010).
[93] I.R.C. § 412(e)(3)(A).
[94] I.R.C. § 412(e)(3)(B).
[95] I.R.C. § 412(e)(3)(C).
[96] *Id.*

premium payments must have been paid for that year and all previous years;[97] (f) there not be any outstanding policy loans for the given benefit year;[98] and (g) the life insurance contract not be subject to any security interest during the given benefit year.[99]

c. Revenue Rulings Attacking Abusive I.R.C. § 412(e)(3) Plans

In 2004, the IRS issued two revenue rulings, Rev. Rel. 2004-20 and Rev. Rul. 2004-21, designed to eliminate abusive transactions involving life insurance.[100] These rulings were aimed at: (i) ensuring that I.R.C. § 412(e)(3) plans were taxed at their fair market value;[101] (ii) ensuring the I.R.C. § 412(e)(3) plans did not discriminate in favor of highly compensated employees by giving such persons better purchase options;[102] and (iii) causing abusive plans to lose their specialized treatment by making them listed transactions.[103] The two rulings targeted specific I.R.C. § 412(e)(3) plan abuses However, the fact that the rulings made the arrangements listed transactions means that the rulings would also apply in various other substantially similar transactions.[104]

In Rev. Rul. 2004-20, the IRS announced their concern that employers were deliberately buying excessive amounts of insurance, under I.R.C. § 412(e)(3) plans, in order to inflate current contribution deductions.[105] The IRS further opined that excess death benefits were being used to subsidize plan investments.[106] Rev. Rul. 2004-20 concludes that if the insurance provides greater lifetime benefits than the plan itself promises,[107] the plan will continue to be qualified under the general defined benefit rules, but will not obtain relaxed minimum funding and accrual rules accorded solely to I.R.C. § 412(e)(3) plans.[108]

Rev. Rul. 2004-20 designated the following five identifying markers of abusive I.R.C. § 412(e)(3) plans.[109] First, the plan would be designed for the cash surrender value to be initially and temporarily depressed significantly below the

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[97] I.R.C. § 412(e)(3)(D).
[98] I.R.C. § 412(e)(3)(F).
[99] I.R.C. § 412(e)(3)(E); 26 C.F.R. § 1.412(i)-1.
[100] Rev. Rul. 2004-20, *supra* note 16; Rev. Rul. 2004-21, *supra* note 16; Simmons & Leimberg, *supra* note 13.
[101] Rev. Proc. 2004-16, 2004-10 I.R.B. 559 (discussing fair market valuation in the context of I.R.C. § 412(e)(3) plans).
[102] *See* Rev. Rul. 2004-21, *supra* note 16.
[103] Simmons & Leimberg, *supra* note 13.
[104] *Id.*
[105] Rev. Rul. 2004-20, *supra* note 16; Simmons & Leimberg, *supra* note 13.
[106] *Id.*
[107] E.g. an insurance policy that provides benefits at normal retirement age in excess of the participant's benefits at normal retirement age under the terms of the plan.
[108] Rev. Rul. 2004-20, *supra* note 16; Simmons & Leimberg, *supra* note 13.
[109] *Zarella*, 755 F. Supp. 2d 1218.

premiums paid and the fair market value of the plan.[110] Second, after about five years, the policy would be sold to the employee for the amount of the current cash surrender value - which would still be depressed.[111] Third, the policy would be structured so that the cash surrender value would increase significantly after the policy was transferred to the employee.[112] Fourth, the "springing" cash value would give employers tax deductions in amounts greatly exceeding what would be recognized by the employee in income or otherwise.[113] Lastly, the death benefits provided under the plan would be greater than those paid to the employee under the retirement plan, which would essentially pay back the employer for the plan contributions.[114]

Rev. Rul. 2004-21 provides that a plan funded by life insurance, which discriminates in favor of highly compensated employees in violation of I.R.C. § 401(a)(4), will not enjoy the relaxed minimum funding and accrual requirements accorded to I.R.C. § 412(e)(3) plans.[115] Rev. Rul. 2004-21 makes such an arrangement a listed transaction, allowing the IRS to impose penalties for deficiencies arising out of a taxpayer's discriminatory failure to conform to the minimum funding and accrual requirement for I.R.C. § 412(e)(3) plans or substantially similar transactions.

d.Civil Lawsuits and Criminal Prosecutions Related to I.R.C. § 412(e)(3) Plans

The IRS enforcement actions against I.R.C. § 412(e)(3) plans have resulted in civil lawsuits against promoters and life insurance companies, as well as criminal prosecutions of promoters. Subsequent to the 2004 issuance of the two revenue rulings, Pacific Life Insurance Company found itself in multiple lawsuits involving fraud, negligent misrepresentation, and other claims based on the marketing of 412(e)(3) plans.[116] The plaintiffs in each case lost at the summary judgment level, but these cases show that the IRS enforcement efforts have driven taxpayers to seek retribution for promoters selling them life insurance products that are deemed improper by the IRS and the courts. Furthermore, attorneys have been civilly enjoined from and publicly censured for the marketing and promotion of abusive I.R.C. § 412(e)(3) as tax shelters.[117]

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[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Id.*
[115] Rev. Rul. 2004-21, *supra* note 16.
[116] *Zarella*, 755 F. Supp. 2d 1218; Patel v. Pac. Life Ins. Co., 2009 WL 1456526 (N.D. Tex. 2009).
[117] *See* U.S. v. Davison, 691 F. Supp. 2d 1033, 1037 (W.D. Mo. 2009); Press Release, *U.S. Court Bars Kansas City-Area Attorney & CPA from Promoting Tax Fraud Schemes That Cost Treasury*

e. I.R.C. § 412(e)(3) Plans Conclusions

I.R.C. § 412(e)(3) plans were deemed abusive if they allowed highly compensated employees to purchase their plans at the cash surrender value for the previous year, rather than fair market value.[118] The reduced purchase price had the effect of allowing for an overly aggressive tax-deductible contribution into the plan (paid into a life insurance policy), followed by a low cost distribution of the life insurance policy back to the original funder of the plan contributions. Additionally, these plans discriminate against rank and file employees by freezing them out, while highly compensated owner-employees greatly benefit.[119] While I.R.C. § 412(e)(3) plans are intended for the benefit of employees, when executives of a company vote to create plans in their favor and claim the plan contributions as business deductions, the scheme is viewed as simply abusive.[120] Thus, just as it had done with I.R.C. § 419 plans, the IRS again expressed its intention to use tough enforcement actions to stop promoters and taxpayers from aggressively deducting impermissible levels of life insurance premiums — even when some modest level of deductible contributions would be permissible to the defined contribution plan.

Promoter devices for buying life insurance in a tax-advantaged way have not been limited to deductible contributions to qualified plans. In the next section of this article, the tax-advantaged financing of life insurance provides another vehicle (COLI) that has been used to make life insurance purchases more attractive.

3. Tax Advantaged Financing: COLI

Corporate owned life insurance ("COLI") consists of policies taken out by companies on the lives of their employees, directors, officers, and owners.[121] The company is the beneficiary of these policies and receives all payments made by the policies, including death benefits.[122] In order to be considered a COLI policy, the policy must meet the definition of a life insurance contract pursuant to I.R.C. § 7702.[123] COLI has been used for many purposes, including, but not limited to: funding employee compensation and benefits; indemnifying the

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at Least $45 Million Department of Justice Tax Division (May 12, 2010), *available at* http://www.justice.gov/opa/pr/2010/May/10-tax-556.html.

[118] Rev. Rul. 2004-20, *supra* note 16; Rev. Rul. 2004-21, *supra* note 16.

[119] *See* Rev. Rul. 2004-21, *supra* note 16.

[120] *See* Rev. Rul. 2004-20, *supra* note 16; Rev. Rul. 2004-21, *supra* note 16.

[121] BAIRD WEBEL & DONALD J. MARPLES, CONG. RESEARCH SERV., RL 33414, CORPORATE-OWNED LIFE INSURANCE (COLI): INSURANCE AND TAX ISSUES (2000), *available at* http://www.docstoc.com/docs/ 53680026/Corporate-Owned-Life-Insurance-%28COLI%29-Insurance-and-Tax-Issues.

[122] *Id.*

[123] *See generally* I.R.C. § 7702 (after all, to be considered Corporate-Owned *Life Insurance*, the policies must first meet the basic definition of a life insurance contract).

business in the event that a key employee dies; funding buy-outs of a deceased partner's or shareholder's ownership interest; and investing through policies known as "Janitor life insurance" or broad-based COLI plans.

Prior to 1986, it was permissible for companies to fully deduct the interest expense incurred on such COLI policies. However, the enactment of the Tax Reform Act (TRA) of 1986[124] limited this amount to $50,000 per policy.[125] Companies responded to this by expanding the number of employees on whom they carried COLI policies.[126] Companies used these broad-based plans to create "no pay" COLI policies, which resulted in major deductions.[127] These COLI policies were created using the "four of seven" safe harbor provision of I.R.C. § 264.[128] Under this type of plan, the owner of the policy paid little to no part of the premium or interest due under the policy.[129] The premium and interest payments were funded by loans taken against the policy's value during the first three years of the plan.[130] The interest rates on these policy loans were chosen by the owners to be the highest rate possible.[131] Later, in years four through seven, the premium and interest payments were paid through loading dividends and surrenders of policy value.[132] As one court determined, "in the end, the policy holder pays nothing for the insurance through a circular flow of internally-generated policy funds to pay premiums."[133] Ultimately, these broad-based COLI plans created a positive cash flow based solely on the tax benefits, which were created based on the interest deduction taken under I.R.C. § 163(a).[134]

Enactment of the Health Insurance Portability & Accountability Act of 1996 ("HIPPA") ended the use of broad-based COLI plans by eliminating the interest deduction on policy loans for employees that were not key persons.[135] HIPPA defines the term "key person" as an officer or 20% owner.[136] Additionally, Congress amended the I.R.C. in 1997 to limit the availability of interest deductions through pro rata allocations.[137] However, this legislation did not affect policies covering employees or key men, because it was intended to

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[124] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat 2085 (1986).

[125] Webel & Marples, *supra* note 121.

[126] *Id.*

[127] *In re* CM Holdings, Inc., 221 B.R. 715, 717 (D. Del. 1998).

[128] *See* I.R.C. § 264.

[129] *In re CM Holdings, Inc.*, 221 B.R. at 717.

[130] *Id.*

[131] *In re CM Holdings, Inc.*, 301 F.3d at 100.

[132] *In re CM Holdings, Inc.*, 221 B.R. at 717.

[133] *Id.* at 715, 718.

[134] *Id.* at 718.

[135] Heath Insurance Portability & Accountability Act (HIPA) of 1996, Pub. L. No. 104-191, 110 Stat 1936 § 501 (1996).

[136] *Id.*

[137] I.R.C. § 264(f).

end the practice of companies taking out life insurance policies on borrowers and other debtors.[138] In addition to legislation, the IRS went after COLI plans in the courts.

Between 1999 and 2001, the IRS litigated and won three cases regarding COLI using the economic substance doctrine as the backbone of the government's argument.[139] In those cases, the courts looked at the company's pre-deduction projected cash flows, the mortality gains to the beneficiary, and the interest-free inside build-up of the policies to determine whether there were economic benefits to the COLI policies other than the tax benefits.[140] In each case, the dividend loading features, which were used to pay the premium charges in some years, were considered to be "factual shams" because the dividend was really a refund.[141] Ultimately, the entire COLI policy in each case was found to lack economic substance because the plans, generated by negative cash flows, were effectively mortality neutral, and there was little to no inside build-up within the policies.[142] The IRS asserted other judicial tax doctrines against COLI, but without much success. The form over substance doctrine was primarily used to place the burden on the taxpayer to show that the form of the COLI transactions reflected their substance.[143]

In 2002, after a series of victories, the IRS issued Announcement 2002-96 stating that all future COLI litigation would be "vigorously" prosecuted or defended.[144] Prior to this, there was a settlement initiative aimed at broad-based COLI plans, thereby allowing settlement when the company involved agreed to concede 80% of the claimed COLI deductions.[145] Currently, I.R.C. § 101(j)[146] is the most pertinent law regarding COLI policies. This provision was enacted in 2006 as part of the Pension Protection Act ("PPA") of 2006.[147] Many of the traditional uses of COLI are still allowed today, such as indemnification of the business in the event of loss of a key employee or funding the buy-out of a deceased partner's ownership interest. However, COLI used for investment purposes is no longer allowed based upon application of the economic substance doctrine. The multi-faceted attack represented by legislation, an IRS settlement initiative, IRS announcements of policy, and court challenges against COLI all

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[138] Webel & Marples, *supra* note 121.
[139] *Winn-Dixie, Inc.*, 113 T.C. 254; *In re* CM Holdings, Inc., 254 B.R. 578 (D. Del. 2000); *Am. Elec. Power, Inc.*, 136 F. Supp. 2d 726.
[140] Dow Chem. Co. v. U.S., 435 F.3d 594, 600 (6th Cir. 2006).
[141] *Am. Elec. Power*, 136 F. Supp. 2d at 784.
[142] *Id.* at 795.
[143] *Id.* at 785.
[144] I.R.S. Ann. 2002-96, *supra* note 17.
[145] *Id.*
[146] I.R.C. § 101(j).
[147] Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat 780 (2006).

act as another indication of the IRS' determination to not permit aggressive tax-advantaged funding of life insurance premiums.

Of course, taxpayers have also used insurance vehicles that do not involve life insurance to achieve tax advantages. Promoters have used Captive Insurance Companies ("CIC") both without life insurance (see PORCs, immediately below) and with life insurance (discussed later in this article).

4. Abusive Captive Insurance Companies: PORCs

A CIC is a corporation created to offer insurance to companies that are related parties to the CIC, often where the CIC owners also own the insured company.[148] The non-tax benefits of a CIC include: (i) premium cost stabilization; (ii) elimination or reduction of brokerage commissions and marketing expenses; (iii) lower administrative costs;[149] (iv) the ability to provide niche coverage for a unique or specific risk that would not otherwise be transferable in the commercial insurance market; (v) and the potential to control certain CIC investment decisions and portfolio management.[150] The tax benefit of an I.R.C. § 831(b) CIC are also extensive.

Premiums paid to a CIC by its insured shareholder are generally deductible, similar to the deductibility of premiums paid on commercial insurance.[151] I.R.C. § 162(a) provides that there shall be allowed deductions on necessary and ordinary expenses incurred in carrying on a business,[152] and Treas. Reg. 1.162-1(a) states that business expenses include insurance premiums on policies covering certain business losses.[153] I.R.C. § 831(b) provides that certain electing insurance companies may receive tax-free annual premiums up to $1.2 million,[154] although the CIC would still be liable for tax on its investment earnings. As such, the insured shareholder 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 be at long-term capital gains rates (15%)[155] instead of ordinary income rates (35%).[156] However, to achieve these tax benefits, a CIC must be considered an "insurance company" and the arrangement must be

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148 Adkisson, *supra* note 18.

149 *See id.*

150 *See id.*

151 *See* I.R.C. § 162(a); Treas. Reg. § 1.162-1(a) (as amended in 1993).

152 I.R.C. § 162(a).

153 Treas. Reg. §1.162-1(a).

154 *See* I.R.C. § 831(b)(2).

155 *See* Rev. Proc. 2008-66, 2008-45 I.R.B. 1107 (2008) (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 15%).

156 *See* I.R.C. § 162; *see also* I.R.C. § 11(b).

considered an "insurance contract".[157] To meet the "insurance" requirements, each CIC with U.S. shareholders must use IRS safe harbors or otherwise show: (i) that the risk of economic loss properly shifts ("risk shifting") from the insured to the insurer; and (ii) that the insurer adequately distributes 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.[158]

One of the more aggressive uses of an I.R.C. § 831(b)[159] CIC is to reinsure risks associated with their businesses through producer owner reinsurance companies ("PORC").[160] Car dealers, furniture stores, rent-to-own stores, credit card companies, and other lenders have all used a PORC for these purposes.[161] Commonly re-insured products include extended service contracts, credit life and disability insurance, theft and property damage insurance, credit card and loan default insurance, and unemployment insurance.[162] As discussed above, the use of an I.R.C. § 831(b) CIC in a PORC transaction is tax-advantaged because the PORC would only be taxed on its investment income.[163] The use of a CIC in a PORC transaction also potentially allowed for a current premium deduction in comparison to the deductibility of self-insurance reserves.[164] Without the use of a captive, the funds set aside for self insurance could not be deducted until they were paid out as a claim or qualifying loss event.[165]

The IRS was concerned that taxpayers were using PORC transactions "to divert income properly attributable to the taxpayer to a wholly owned company that was subject to little or no federal income tax."[166] In analyzing the deductibility of contributions to a PORC and the excludability of premium income under I.R.C. § 831(b), the IRS generally considers several factors, including: (i) whether there exists a nontax business purpose for the transaction; (ii) whether the entity is adequately capitalized; (iii) whether the transaction was at arms length and is otherwise commercially reasonable; (iv) whether the entity faces regulatory oversight; and (v) whether there exists sufficient risk shifting and

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157 *See* Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835, 838 (6th Cir. 1995); Treas. Reg. 1.162-1(a).
158 Humana, Inc. v. Comm'r, 881 F.2d 247 (6th Cir. 1989).
159 *See* I.R.C. § 831(b).
160 I.R.S. Notice 2002-70, *supra* note 16.
161 *Id.*
162 *Id.*
163 I.R.C. § 831(b).
164 *See* I.R.C. § 162(a) (2006); Treas. Reg. § 1.162-1(a) (as amended in 1993); Steere Tank Lines, Inc. v. U.S., 577 F.2d 279, 282 (5th Cir. 1978).
165 *Steere Tank Lines, Inc.*, 577 F.2d at 282; 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).
166 I.R.S. Notice 2002-70, *supra* note 16.

risk distribution to constitute insurance.[167] In order for there to be arm's length and commercial dealing, six factors must exist: (i) timely payments of premiums; (ii) actual claim review and readjustment; (iii) regular administrative functions commonly found in an insurance company; (iv) formal entry into contracts; (v) lack of rebating of premiums; and (vi) investment of capital into reserves with diversified portfolios.[168]

In 2002, the IRS issued Notice 2002-70, which converted the PORC into a listed transaction.[169] The IRS also informed taxpayers of how it planned to attack PORCs in IRS Notice 2002-70.[170] First, the company would have to show that its primary and predominant purpose was insurance.[171] To meet this test, at least 50% of the company's business must consist of the issuance of insurance or annuity contracts and/or the reinsurance of risks underwritten by other insurance companies.[172] Second, the IRS planned to evaluate the pricing of the insurance to ensure that it was at arm's length.[173] Lastly, the IRS would use the sham transaction doctrine to attack PORCs.[174] However, the IRS did not maintain that every PORC transaction would be a sham.[175]

Just two years after making PORCs a listed transaction, the IRS issued another notice de-listing PORCs because the IRS had discovered fewer abusive PORC transactions than anticipated.[176] The IRS de-listing did not eliminate the listed transaction reporting requirements for previously entered-into PORCs. The IRS also stated that it would continue to aggressively combat PORCs using the same arguments contained into the original listing notice. Of course, the de-listing still leaves open the possibility that the IRS could re-list PORC transactions at a later date, should the IRS determine that the abusive form of the PORC transaction is more prevalent. The bottom line is that the PORC listing and challenges stated in the listing notice evidence a continued IRS policy of disallowing aggressive tax-deductions in the context of insurance.

As discussed above, the IRS has used its enforcement powers (together with Congressional legislations) to attempt to deter the promotion and use of insurance vehicles to facilitate improper tax benefits. The practices attacked by the IRS have included: (i) taking aggressive deductible contributions into

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[167] Elliott, *supra* note 15.
[168] *Id.* at 43; *see also* Sears, Roebuck & Co. v. Comm'r, 972 F.2d 858 (7th Cir. 1992).
[169] I.R.S. Notice 2002-70, *supra* note 16.
[170] *Id.*
[171] *See* I.R.C. § 816(a); Treas. Reg. § 1.801-3(a) (stating that 50% of the business of an insurance company must be insurance in order to qualify).
[172] *Id.*
[173] I.R.S. Notice 2002-70, *supra* note 16.
[174] *Id.*
[175] I.R.S. Field Service Announcement 200027008, *available* at 2000 WL 33116160.
[176] I.R.S. Notice 2004-65, 2004-2 C.B. 599 (2004).

qualified plans for the payment of life insurance premiums; (ii) using tax-advantaged financing vehicles for the purchase of life insurance; and (iii) making impermissible tax-deductible premium payments for business insurance to a CIC. In the next section, this article will seek to synthesize a generalized IRS policy towards different or new tax-avoidant insurance transactions.

5. Analysis: Synthesizing and Summarizing IRS Policy

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.[177] In addition, the taxpayer bears the burden of proving that a claimed expense or loss is deductible.[178] Over the years, Congress has offered almost no exceptions to the general rule of life insurance premium non-deductibility for businesses. For instance, the few available exceptions include: (i) proper contributions to a qualified retirement plan (which in turn can buy limited amounts of life insurance), and (ii) a business deduction for interest on $50,000 used to purchase key man life insurance policies.[179] However, the IRS still closely monitors the areas of Congressional exception for abuses. Historically, the IRS has considered the following circumstances as indicative of potential abuse in the life insurance area: (a) tax-advantaged payment of life insurance premiums to accumulate assets;[180] (b) circular cash flows used to pay policy premiums;[181] and (c) discriminatory life insurance benefits.[182]

a. Tax-Advantaged Payment of Life Insurance Premiums to Accumulate Assets

One area of IRS concern is any vehicle involving the use of tax-advantaged payment of life insurance premiums to accumulate assets, including I.R.C. §§ 419 and 412(e)(3) plans.[183] The IRS is extremely suspect of a business using any tax-advantaged method of funding permanent life insurance with an

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177 Zaritsky & Leimberg, *supra* note 24.

178 *Am. Elec. Power, Inc.*, 136 F. Supp. 2d at 778.

179 I.R.C. § 264(e).

180 *See generally Curcio*, T.C.M. 2010-115 ("the means through which covered employees could procure a distribution of those underlying policies all lead us to conclude that Benistar Plan is a thinly disguised vehicle for unlimited tax-deductible investments").

181 *See generally In re CM Holdings, Inc.*, 221 B.R. at 718 (holding that the IRS met its burden of showing non-decutibility where "the policyholder pays nothing for the insurance through a circular flow of internally-generated policy funds to pay premiums").

182 *See* Rev. Rul 2004-21, *supra* note 16.

183 *See generally Curcio*, T.C.M. 2010-115 ("the means through which covered employees could procure a distribution of those underlying policies all lead us to conclude that Benistar Plan is a thinly disguised vehicle for unlimited tax-deductible investments"); Rev. Rul. 2004-20, *supra* note 16 (holding that employer contributions under a qualified defined benefit plan that are used to purchase life insurance coverage—on a pretax basis, i.e. tax-advantaged—for a participant in excess of the participant's death benefit are not fully deductible upon contribution).

investment element, for the purpose of accumulating assets within the policy.[184] As outlined above, key man policies are the only non-retirement semi-income tax-advantaged life insurance policies available. However, the tax benefit for purchasing a key man policy is very minimal (deductible interest on $50,000 in loan to pay premiums), and the goals of key man insurance can normally be met using term life insurance policies.[185] The use of whole, variable, or universal life insurance policies to insure key persons may simply add an additional and unnecessary investment portion to the arrangement.[186]

The additional investment portion of the arrangement may cause premiums to be inflated over the amount actually needed to fulfill the stated goals of the business in carrying key person insurance.[187] The IRS reasons that allowing significant income tax benefits (such as deductible premiums) on investment portions of premiums paid would essentially funnel pre-tax business profits to an insurance investment that already enjoys other Congressionally mandated tax benefits.[188] In IRS Notice 2002-70, the IRS stated a clear policy against "divert[ing] income properly attributable to the taxpayer to a wholly owned company that was subject to little or no federal income tax."[189] To the extent that a business can shift taxable income to a tax-free investment, this result would likely be objectionable by the IRS. Since a life insurance policy has a tax-free internal build-up and death benefit (both described below),[190] any life insurance policy having additional tax advantaged premium payments (such as a deduction) would violate the above-stated IRS anti-"diversion" tax policy.[191]

b. Circular Cash Flows Used to Pay Policy Premiums

Another area of IRS concern is any vehicle that uses circular cash flows to pay policy premiums on a life insurance policy, including impermissible COLI arrangements. The IRS is suspect of arrangements in which insurance coverage is

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[184] Rev. Rul. 2004-20, *supra* note 16.

[185] *See generally* I.R.C. § 264(e) (limiting the deductible interest on key man life insurance loans to $50,000); *Neonatology Associates, P.A.*, 299 F.3d at 233-34 (holding taxpayers liable for the I.R.C. § 6662 accuracy-related penalties where such taxpayers were physician-owners who caused their professional corporations to overpay considerably for life insurance, when the only needed coverage was relatively inexpensive term life insurance coverage, knowing that the money could be rerouted circuitously to their personal coffers).

[186] *See generally Neonatology Associates, P.A.*, 299 F.3d at 233-34 (holding taxpayers liable for the I.R.C. § 6662 accuracy-related penalties where such taxpayers were physician-owners who caused their professional corporations to overpay considerably for life insurance, when the only needed coverage was relatively inexpensive term life insurance coverage, knowing that the money could be rerouted circuitously to their personal coffers).

[187] *Id.* at 45.

[188] *Curcio*, T.C.M. 2010-115 at 13.

[189] I.R.S. Notice 2002-70, *supra* note 16.

[190] I.R.C. § 101(a)(1); Brumbaugh, *supra* note 5.

[191] *See* I.R.S. Notice 2002-70, *supra* note 16.

generated, with negative cash flows, through the rebating of accumulated cash values and/or death benefits.[192] The IRS would be especially weary of scenarios involving (i) a mortality neutral policy, (ii) little to no inside build-up within the policy,[193] and (iii) a "circular flow of internally-generated policy funds to pay premiums."[194] Anything that operates in a similar manner to finance life insurance premiums to a COLI arrangement would likely be equally as suspect to the IRS.

c. Policy Against Discriminatory Life Insurance Benefits

A third area of IRS concern is any vehicle that creates discriminatory tax and/or life insurance benefits for a select group of top company owners, including aggressive versions of (i) I.R.C. § 419 plans, (ii) I.R.C. § 412(e)(3) plans, and (iii) I.R.C. § 831(b) CIC PORCs. The IRS is particularly suspect of arrangements (such as §§ 419 or 412(e)(3) plans) where businesses fund life insurance policies for the benefit of owners, executives, and/or other highly compensated employees in a manner that discriminates against other employees.[195] The IRS is wary of allowing life insurance premium deductions, in addition to the other congressionally mandated tax benefits associated with life insurance, that would provide a very tax beneficial alternative form of compensation to top company owners and employees.[196] Yet tax benefits afforded to common company owners of the insured and the insurance company in an impermissible non-life insurance CIC PORC arrangement would also likely be seen as discriminatory.

One of the key policy reasons for the IRS to so aggressively challenge transactions that combine the above factors is that tax-advantaged insurance arrangements (particularly those involving life insurance) already have Congressionally mandated tax benefits. The following section of this article is a description of the tax benefits that life insurance traditionally affords, and a discussion of how extending these benefits by adding additional tax advantages would likely violate Congressional intent and IRS policy.

C. The Tax Benefits of Life Insurance

Congress and the IRS have taken hard stances against tax-oriented insurance schemes, in part, because the life insurance industry has already received preferential tax treatment in the forms of deferring gain on internal build-up[197] and a tax-free distribution to beneficiaries payable by reason of death

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[192] *See* Rev. Rul. 2004-20, *supra* note 16.
[193] *American Elec. Power, Inc.*, 136 F. Supp. 2d at 795.
[194] *In re CM Holdings, Inc.*, 221 B.R. at 718.
[195] Rev. Rul. 2004-21, *supra* note 16.
[196] *See id.*
[197] I.R.C. § 72(e)(5)(A).

of the insured.[198] In fact, the National Association of Insurance and Financial Advisors estimate that taxing life insurance inside build-up would generate additional revenue of $149.5 billion between tax years 2010 and 2014.[199] The Center for American Progress has similarly reported that the deferment or exclusion of inside build-up is a tax subsidy expected to cost the federal government $129 billion in revenues between 2012 and 2016.[200] The life insurance industry and millions of individual policyholders share the benefit of this tax expenditure subsidy. The public policy behind the favorable tax treatment that the life insurance industry has enjoyed is to encourage families to protect themselves financially from the unexpected loss of a provider.[201] Historically, the life insurance industry has marketed life insurance policies primarily to the middle class; however, there has been a growing trend of wealthy people using permanent life insurance for estate planning and investment purposes, due to the tax benefits discussed herein.[202]

1. Tax-Free Internal Build-Up

Internal build-up is a feature of 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.[203] Inside build-up occurs when policy premiums exceed the amount required to pay for the cost of insurance during the premium period.[204] Inside build-up often occurs during the early years of a whole life insurance policy since whole life maintains level premiums but the actual cost of insuring the risk of death is much lower in the insured's younger years.[205] Accordingly, internal build-up adds an investment and savings component to the life insurance industry.[206]

Inside build-up receives favorable tax treatment since gain from inside build-up investment is either: (1) deferred until the insurance policy is

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198 I.R.C. § 101 (excluding death benefits from income).

199 *Taxes and the Federal Budget Debate: Implications for Advisors and Their Clients*, THE NAIFA BLOG (Feb. 16, 2011, 11:47 AM), http://www.naifablog.com/2011/02/taxes.html.

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

201 *See id.*

202 *Id.*

203 I.R.S. Tech. Adv. Mem. 200213010 *supra* note 1.

204 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.

205 *See generally id.* (stating that the inside buildup consists of both a cash value and death benefit component, taken from level premiums throughout the life of the policy, thereby leading to the conclusion that inside buildup will be greatest when the insurance coverage component is the smallest—i.e. when an insured is young and has relatively few health problems).

206 *Id.*

surrendered for cash prior to the death of the insured; or (2) completely excluded from income forever if paid out as part of the policy death benefit, due to the life insurance income tax exclusion.[207] 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.[208] Life insurance inside build-up has gone untaxed largely because of the difficulty in taxing people on gains in life insurance policies that are not realized in cash.[209]

2. Tax-Free Death Benefit

When a life insurance contract pays out by reason of death of the insured, the amount paid out to the recipient goes untaxed; meaning the recipient excludes from his gross income the gains on the premiums paid into the policy.[210] The death benefit income tax exclusion allows for income-tax-free receipt of the life insurance death benefit (received as a lump sum), provided the amount received does not exceed the policy's stated death benefit amount.[211]

3. Summary of Tax Consequences: Taxed Only on Income Prior to Use for Premiums

Except for certain allowed tax arrangements such as eligible 412(e)(3)[212] and 419 plans[213], life insurance must be purchased with after-tax dollars.[214] This means that profits used to pay life insurance premiums is first subject to income taxation.[215] However, all investment income accrued after payment of life insurance premiums, within a whole or variable life insurance policy, shall enjoy tax-deferred status until such income is realized upon surrender of the policy for cash prior to the death of the insured.[216] If the policy is terminated by death of the insured, the investment income accrued after premium payments have been made shall be forever exempt from income taxation.[217]

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[207] I.R.C. § 101(a)(1); Brumbaugh, *supra* note 5.
[208] Brumbaugh, *supra* note 5.
[209] *See* Hanlon & Eizenga, *supra* note 200 (proposing a solution to this difficulty by taxing the insurance companies themselves on investment gain from premiums paid).
[210] I.R.C. § 101(a)(1).
[211] Brumbaugh, *supra* note 5.
[212] *See* 26 C.F.R. § 1.412(i)-1.
[213] *See* I.R.C. § 419A.
[214] I.R.S. Tech. Adv. Mem. 200213010, *supra* note 1.
[215] *See id.*
[216] I.R.C. § 101(a)(1); Brumbaugh, *supra* note 5.
[217] Brumbaugh, *supra* note 5.

4. Analysis: Tax-Deductible Premiums Would Result in 100% Tax Avoidance

The IRS' position is that allowing taxpayers to receive currently deductible premiums or loan interest expense paid, as well as a tax-deferred internal build-up and a death benefit exclusion, would create the opportunity for tax arbitrage by policyholders, particularly by wealthy small business owners.[218] The IRS' main contention is that a taxpayer should not be able to take current deductions on assets that produce deferred or exempt income.[219]

The IRS reasons that if premiums paid are currently deductible, then the other existing benefits of life insurance may make the entire transaction into the perfect tax shelter.[220] 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 a means to escape taxation completely on discretionary income.[221] Deductible premium payments would likely incentivize taxpayers to take advantage of this opportunity to minimize their income and estate tax liabilities, leading to potentially widespread abuses.[222] Of course the taxpayers who would most likely be able to make use of such a tax shelter would be the wealthy, creating a discriminatory tax benefit for high-income taxpayers.

a. Policy Against Discriminatory Tax Benefits

Wealthy taxpayers would receive the most advantage from the availability of tax-deductible premium life insurance policy investments.[223] This is because wealthy individuals have enough disposable income to receive the full benefit of investment in life insurance. Most middle class people who live into retirement age will need to cash in large portions of their whole life inside build-up in order to live. This is one of the main purposes of purchasing whole life insurance among the middle class. However, the effect of such a lifetime partial or full surrender for cash value is to trigger taxation on the inside build-up of the pro rata profit received.[224] As such, absent cases of early death, only wealthy taxpayers with enough disposable income for life-long investments that allow for the maintenance of their accustomed lifestyles during retirement, will be able to garner the full benefits of tax-free death benefit.

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[218] I.R.S. Tech. Adv. Mem. 200213010, *supra* note 1.
[219] *Id.*
[220] *See Id.*
[221] *See Id.*
[222] *Id.*
[223] *Id.*
[224] *See generally* Brumbaugh, *supra* note 5 (stating that life insurance inside buildup enjoys a mere deferral of tax if a policy is surrendered for cash prior to death—with a surrender for cash value triggering taxation).

Therefore, the existence of tax-deductible premiums would discriminatorily favor the wealthy since they will reap all the potential tax benefits. In the small business context, wealthy small business owners would assuredly attempt to claim key person life insurance premiums on policies insuring themselves as ordinary and necessary business deductions under I.R.C. § 162. This result is not possible under current law, since whole life insurance premiums paid by small business owners would likely be treated as non-deductible personal expenses.[225] However, high-income business owners would likely exploit a tax-deductible premium if made available. In addition to the discriminatory nature of such a result, it is also probably poor economic policy to create an incentive to lock up business funds in a life insurance policy for the life of the insured — as discussed in the next part of this article.

b. Poor Economic Policy

Advocates of supply side economics believe that economic growth can be most effectively achieved by lowering barriers for individuals to supply goods and services — by lowering tax burdens, for example. Over the course of time, a country's standard of living is generally directly correlated to the country's supply and production levels.[226] Wealthy individuals have the disposable investment income to theoretically increase the nation's production levels and should therefore be incentivized to do so.

A deduction in marginal income tax rates is the traditional way to incentivize such investment,[227] and some advocates of low tax rates would likely see a tax deduction for insurance premiums in a similar light, since it lowers effective taxation for those who take advantage of the deduction. The problem with this analysis is that the deduction would only result in taxes being lowered on income that will end up being trapped inside a life insurance policy. As such, a new life insurance premium tax deduction would not encourage increased production because it forces untaxed funds that could otherwise be invested in small businesses (or other productive investments) being locked up inside insurance policies for decades.

Given that the IRS policy is to combat tax-deducible life insurance premiums, it is likely that any current transaction with this attribute would garner a great deal of IRS enforcement attention. Such a current transaction — using life insurance in a captive insurance company — is discussed below.

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225 26 C.F.R. § 1.264-1.

226 James D. Gwartney, *Supply-Side Economics,* THE CONCISE ENCYCLOPEDIA OF ECONOMICS (2008), http://www.econlib.org/library/Enc/SupplySideEconomics.html.

227 *Id.*

II. THE USE OF AN I.R.C. § 831(B) CIC TO CREATE DEDUCTIBLE LIFE INSURANCE PREMIUMS

A. The Transaction: Life Insurance as an "Investment" of the CIC

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.[228] An ordinary and necessary business expense is tax deductible, so the CIC premiums are paid with pre-tax dollars from the small business.[229] In the context of an I.R.C. § 831(b) CIC,[230] up to $1.2 million per year in premiums paid would be excluded from the taxable income of the CIC.[231] This means that a CIC receiving less than $1.2 million in annual premiums would only face taxation on investment income. 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. Theoretically, the CIC could then purchase life insurance on the small business owner's life with pre-tax dollars as an investment.[232] As such, the CIC's purchase of life insurance on the common owner of the insured entity and CIC (hereinafter referred to as the "Insurance Transaction") would clearly fit the IRS definition of the perfect tax shelter — (i) deducible premiums into the life insurance policy; (ii) tax-free build-up inside the life insurance policy; (iii) a subsequent distribution of the life insurance policy at currently tax-advantaged capital gains rates; and (iv) an income and estate tax-free payment of the life insurance proceeds upon the death of the insured. Given the IRS history of attacking transactions such as I.R.C. §§ 419 and 412(e)(3) plans and I.R.C. § 831(b) CIC PORCs, it is likely that the IRS would mount a similar attack on this transaction.

B. Analysis: Historical Likelihood of an IRS Attack on a CIC's Investment in Life Insurance

1. Principal Purpose Tax Avoidance - Not Insurance: the PORC Attack

The Insurance Transaction is subject to a similar line of generalized attack as was made against the CIC PORC transaction — that the CIC's principal purpose is tax avoidance, not insurance. In the CIC PORC transactions, the IRS considered several factors in weighing whether the insurance premium paid to the CIC would be deductible. As outlined above, these factors included in part: (i) the

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[228] *See* I.R.C. § 162(a).
[229] *See id.*; Adkisson, *supra* note 18.
[230] I.R.C. § 831(b).
[231] *See id.*
[232] Adkisson, *supra* note 18.

existence of a nontax business purpose for the transaction; (ii) the arms length nature of the transaction (including whether the reserve portfolio was properly diversified); and (iii) the existence of proper risk shifting and distribution.[233]

a. Non-Tax Business Purposes

In analyzing whether a taxpayer may validly deduct CIC insurance premium payments, the court will look to whether the substance of the funds set aside were truly business expenses.[234] A legitimate corporate entity (including a CIC) will ordinarily not be disregarded for tax purposes where the entity is created for legitimate business purposes or actually taxed separately. However, there are situations in which transactions between separate but related entities (like the CIC and its commonly owned insured entity) may be aggregated to treat the transaction as occurring between a single taxpayer, particularly where the transaction is entered into for the purposes of evading income tax.[235]

In the Insurance Transaction, the conduit nature of the CIC insurance premiums into personal life insurance on a common owner is likely to make it difficult to prove that the CIC was created for proper non-tax business purposes. Of course, the CIC can attempt to mitigate this argument by conducting business in all other ways as an insurance company operating independently of the common ownership. However, the close relationship among the parties, combined with the use of CIC premium payments for life insurance on the life of an insider, will likely warrant the IRS weighing the facts and circumstances of the Insurance Transaction carefully in deciding whether a CIC has a proper non-tax business purpose. If the CIC fails to establish such a non-tax business purpose, then the Insurance Transaction will fail.

b. Arm's Length Nature

The arm's length nature of the insurance and investment will be a consideration for any IRS attack on the Insurance Transaction. Premiums paid by a business to a CIC for property and casualty insurance are 100% deductible as ordinary and necessary business expenses,[236] provided the premiums are paid on real insurable risks and are negotiated at arms length.[237] An arms length transaction requires pricing at fair market value and commercially reasonable dealing and terms.[238]

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[233] Elliott, *supra* note 15; *see also Sears, Roebuck & Co.*, 972 F.2d at 41-43.
[234] Spring Canyon Coal Co. v. Comm'r, 43 F.2d 78, 79 (10th Cir. 1930).
[235] Crawford Fitting Co. v. U.S., 606 F. Supp. 136, 143 (N.D. Ohio 1985).
[236] I.R.C. § 162.
[237] *See* Gulf Oil Corp. v. Comm'r, 89 T.C. 1010, 1033-34 (1987).
[238] Excessive fees charged by the CIC for management and formation may draw suspicion since these fees would increase the expenses currently deductible by the parent corporation.

The IRS may attack the Insurance Transaction as failing the arm's length element because the arrangement appears to be a mere conduit for the small business owner to avail themselves of tax benefits. It is unlikely that an independent insurance company would choose in an arm's length deal to make use of its reserves to purchase life insurance on the life of its owner, especially before the insurance company has even proven to be a consistently profitable venture. Aside from the "insider" nature of such an investment, the investment of a significant portion of the reserves in one concentrated vehicle may result in the CIC investment portfolio failing to be diversified in a manner consistent with how an independent insurance company would operate. Newly written life insurance contracts inherently possess significant illiquidity compared to more traditional CIC investments, such as public stocks and bond. Overall, the unlikely nature of this choice of investment on an arm's length basis makes it subject to heightened scrutiny by the IRS.

c. Risk Shifting and Distribution

The requirements of risk shifting and risk distribution of an insurance contract were first pronounced in *Helvering v. Le Gierse*.[239] Risk shifting in an insurance transaction requires a contract between an insuring party and an insured party whereby the parties gamble on the likelihood, size, and frequency of a covered claim. Risk distribution entails the spreading of potential loss throughout a pool or group, so as to minimize the danger that an individual party will be unable to meet its obligations.[240] CIC insurance premium payments are only deductible where both risk shifting and risk distribution exist.[241] Furthermore, a taxpayer who establishes a self-insurance reserve to insure against contingent future losses is not entitled to deduct the funds contributed to the reserve until the liability becomes fixed.[242] The key distinguishing factor between insurance and self-insurance is that self-insurance involves the assumption of risk of one's own loss, whereas insurance involves a transfer of risk between an insured and insurer.[243]

If the funding of the CIC is not truly at arms-length (as described above), the IRS could also argue that risk shifting and distribution has not occurred since a lack of arms length dealing indicates mutual ownership and control.[244] If risk distribution and risk shifting have not occurred, then the transaction between the insured company and the CIC is not an "insurance transaction", and therefore the

239 Helvering v. Le Gierse, 312 U.S. 531, 539 (1941).

240 *Id*. at 539; *see also Crawford Fitting Co.*, 606 F. Supp. at 140.

241 *Id.*

242 *Steere Tank Lines, Inc.*, 577 F.2d at 282.

243 *U.S. v. Newton Livestock Auction Market, Inc.*, 336 F.2d 673, 676 (10th Cir. 1964).

244 *See Gulf Oil Corp.*, 89 T.C. at 1033-34.

expense would not be deductible[245] as ordinary and necessary.[246] As such, a failure to follow proper risk shifting and distribution requirements will lead to an IRS determination that the CIC in the Insurance Transaction is not an "insurance company" at all. Of course, even if the CIC establishes that it has met the definition of an "insurance company," the IRS may still attack the CIC by asserting the IRS general policy against the deductibility of life insurance premiums, discussed below.

2. General Tax Policy Relating to Life Insurance Non-Deductibility

The Insurance Transaction is subject to the same line of tax policy attack as the IRS made against promoters and taxpayers who entered into aggressive I.R.C. §§ 419 and 412(e)(3) plan transactions. I.R.C. § 61(a) provides that taxpayers are taxed on their "Gross Income", which is defined as "all income from whatever source derived."[247] Taxpayers are only permitted to deduct payments from "Gross Income" where a specific statutory deduction permitted under the I.R.C exists. Thus, in the absence of a specific I.R.C. deduction for life insurance premiums, the IRS may deny any such deductions.[248] The I.R.C. does permit certain small means of using tax-deducted funds to buy life insurance,[249] but these methods are very limited.[250] Other than these insignificant exceptions, the general rule enforced by the IRS is that life insurance premiums are not deductible, nor should tax-deducted funds be used to purchase them.[251]

There is no specific statutory prohibition against a CIC investing in life insurance, but the IRS will likely get suspicious where deducted CIC insurance premiums are used in the same year to pay normally non-deductible life insurance premiums on the life of the common owner of the CIC and its insured. Using CIC reserves as life insurance premiums (especially in a life insurance policy on the life of a common owner) may lead the IRS to question if the CIC was created for the primary purpose of making otherwise non-deductible personal life insurance premium expense deductible.[252]

As stated above, the IRS' position is that allowing taxpayers to receive currently deductible premiums, a tax-deferred internal build-up, and the death benefit tax exclusion, would create the opportunity for wealthy small business owners to utilize the perfect tax shelter. The Insurance Transaction meets the

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[245] Furthermore, if the transaction is not considered "insurance" then the death benefits paid may not be eligible for exclusion from the beneficiaries' gross income under I.R.C. § 101(a)(1).
[246] *Crawford*, 606 F. Supp. at 140.
[247] I.R.C. § 61(a).
[248] Zaritsky & Leimberg, *supra* note 24.
[249] Webel & Marples, *supra* note 121.; Zaritsky & Leimberg, *supra* note 24.
[250] I.R.C. § 101(j); Zaritsky & Leimberg, *supra* note 24.
[251] Zaritsky & Leimberg, *supra* note 24; Adkisson, *supra* note 18.
[252] Adkisson, *supra* note 18.

"perfect tax shelter" description above, with the exception that the CIC owner must receive a tax-advantaged 15% tax rate on the dividend distribution of the life insurance policy when it is transferred out of the CIC. Aside from this one time 15% tax, the Insurance Transaction allows the taxpayer to escape taxation completely on significant discretionary income. Small business owners with such discretionary income would not likely pass up such a powerful tax benefit, leading to a wave of abusive tax avoidance. The IRS policy against tax-deductible life insurance premiums exists to prevent such abusive transactions from proliferating. The IRS has shown a willingness to spend very significant enforcement resources to combat such transactions in furtherance of this tax policy, including its multi-year battles against I.R.C. §§ 419 and 412(e)(3) plans. Therefore, a CIC should avoid aggressively investing CIC assets in whole or variable life insurance, and should think twice about using a CIC as a conduit for making an otherwise personal premium expense deductible.[253]

Aside from the general IRS policy against deducting life insurance premiums, the CIC may also apply its above-described policy against the diversion of taxable income into non-taxable investment vehicles — discussed in the next section of this article.

3. Tax-Advantaged Payment of Life Insurance Premiums to Accumulate Assets

The Insurance Transaction is also likely to violate the IRS policy against business owners expanding potentially tax-advantaged key man term life insurance into a permanent life insurance policy to accumulate a tax-free investment.[254] As discussed above, internal build-up is a feature of whole and variable life insurance policies that adds an investment and savings component to the life insurance industry. Key man life insurance held by a business to protect against the loss of service of a critical employee is a well-established reason to place such insurance. Of course, I.R.C. § 264(e) limits the key man insurance's tax benefits to taking a tax deduction for interest on $50,000 in loans used to pay for such policies.[255] The purpose of a key man policy is met by funding the death benefit portion of the policy (i.e., protection of loss of the key employee), so any funds added to the policy on top of the death benefit likely have been contributed for tax-free investment purposes. Tax-free investing is not necessary to meet the goal of key man loss protection. The end result is the inflation of premiums

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253 *Id.*

254 *See generally Neonatology Associates, P.A.*, 115 T.C. at 92 (reasoning that the contributions were non-deductible to the extent that the contributions "w[ere] to serve as a tax-free savings device for the owner/employees and not, as asserted by petitioners, to provide solely term life insurance to the covered employees").

255 *See* I.R.C. § 264(e).

beyond the amount actually needed to fulfill the stated goals of the business carrying key man insurance.[256]

If the key man justification for the policy is missing, or the purported key man policy is aggressively overfunded beyond an amount that would permit the very limited tax benefit, then the IRS will likely view such cash value life insurance policies (i.e. whole and variable policies with inside build-up) with suspicion. The IRS scrutiny may be even more acute if the life insurance policy is purchased by a small business CIC.[257] This is because real insurance companies would not typically purchase life insurance as an investment,[258] especially on the common owner of the insured entity and CIC. Real insurance companies require investments with more liquidity so that the insurance company can feasibly meet policy claims when the claims come due.[259] For that reason, investment instruments that are freely traded in a secondary market (i.e. stock and bonds) are much more appropriate investments for true insurance companies.[260] Insurance companies do not typically use life insurance as an investment vehicle. The IRS historically scrutinizes Congressionally unintended tax benefits derived from life insurance vehicles. Thus, the IRS is likely to crack down on these types of CIC arrangements to prevent taxpayers from making an unorthodox use of life insurance to obtain impermissible tax benefits.

The Insurance Transaction has been viewed as an increasingly common trend in tax shelters.[261] Congress intended that premiums paid on personal life insurance be non-deductible.[262] Life insurance purchased by a small-business owner's CIC may appear to have a business purposes, but this insurance does not benefit anyone other than the small business owner and their family. Historically, the IRS has been extremely suspicious of a business using tax-deductible life insurance to accumulate assets within a life insurance policy.[263] The IRS reasons that allowing deductions on investment portions of premiums paid would essentially funnel pre-tax business profits to an insurance investment that already enjoys other Congressionally allowed tax benefits.[264] In IRS Notice 2002-70, the IRS stated a clear policy against "divert[ing] income properly attributable to the taxpayer to a wholly owned company that is subject to little or no federal income

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[256] *See Neonatology Associates, P.A.*, 115 T.C. at 97-8.
[257] Adkisson, *supra* note 18.
[258] *Id.*
[259] *Id.*
[260] *Id.*
[261] *Id.*
[262] Zaritsky & Leimberg, *supra* note 24.
[263] *Curcio*, T.C.M. 2010-115 at 13.
[264] *Id.*

tax," such as a CIC which is allowed to exclude up to $1.2 million annually in premium income under I.R.C. § 831(b).[265]

In addition to the Insurance Transaction potentially violating the IRS general policy against tax-deductible life insurance premiums, and its policy against shifting business income into tax-advantaged vehicles, the Insurance Transaction may also violate the IRS policy against creating discriminatory tax benefits via life insurance policies as discussed below.

4. Policy Against Discriminatory Tax Benefits

The Insurance Transaction is discriminatory to the benefit of the wealthy, since only the wealthy will reap all the potential tax benefits. First, the formation and administration of a CIC is not inexpensive, making it likely out of the economic reach of middle class taxpayers. Second, at such point as the life insurance policy is distributed out of the CIC to the taxpayer, a middle class taxpayer would have to come up with a lump sum 15% tax payment to the IRS on the dividend. A lump sum of any significance would likely exceed the economic resources of a middle class taxpayer.

Lastly, as discussed above, wealthy small business owners would be the most likely party to have enough discretionary ordinary income that they could leave the tax-deducted premiums locked up in the insurance policy for the life of the insured. Most middle class people will eventually need to access their prior discretionary income as replacement income in retirement. Thus, if middle class taxpayers attempted to make use of the Insurance Transaction, they would likely end up taking distributions out during life that may (i) defund the policy to the point of being unable to sustain internal payment of premiums, or (ii) eventually trigger gains where distributions exceed basis in the policy. In either of these instances, a middle class taxpayer would be unable to take advantage of the tax-free death benefit feature of the Insurance Transaction. As such, the Insurance Transaction likely results in a discriminatory tax benefit to wealthy taxpayer insiders to the exclusion of rank and file middle class employees. The IRS may use this class disparity as a tax policy pretext as part of an overall attack on the Insurance Transaction as an abusive tax shelter. It would not be surprising to see a discussion of this discriminatory benefit analysis as part of a future listed transaction notice or revenue ruling attacking versions of the Insurance Transaction.

III. CONCLUSION

The life insurance community has a long and tortured history of seeking the Holy Grail of insurance schemes: the tax-deductible life insurance premium.

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[265] I.R.C. § 831(b); I.R.S. Notice 2002-70, *supra* note 16.

Nearly every year around tax planning season, life insurance agents attempt to boost year-end sales by offering some kind of tax-deductible premium plan — the newest of which is the small business CIC as an investor in life insurance. Congressional intent is to generally prohibit tax deductions on premiums paid on personal life insurance policies.[266] Congress has explicitly provided certain subsidies to the life insurance industry within the I.R.C., and the absence of a deduction for premiums paid on individual life insurance policies sends an implicit message of non-deductibility. The IRS already loses a substantial amount of otherwise collectible tax revenue due to the existing tax-breaks afforded life insurance policyholders.[267] Therefore, historically, the IRS has staunchly defended the loss of additional life insurance tax revenue by bringing cases against individual taxpayers and promoters, making certain abusive arrangements listed transactions, and imposing accuracy-related taxpayer penalties. The IRS will likely view an arrangement where a small business owner funds a CIC for the primary purpose of obtaining deductions on life insurance premium payments ("Insurance Transaction") as similarly abusive to prior listed transactions involving I.R.C. § 419 plans, I.R.C. § 412(e)(3) plans, and I.R.C. § 831(b) PORCs.

First, as the IRS did with aggressive I.R.C. §§ 419 and 412(e)(3) plan transactions, the IRS would cite the general policy against tax-deductible life insurance premiums. The default rule in the I.R.C. is that all income is taxable, and only specifically I.R.C. codified deductions are allowable.[268] Thus, in the absence of a specific I.R.C. deduction for individual or business life insurance premiums, such premiums are not deductible. It is no more permissible for a taxpayer to use an entity as a direct conduit to achieve such an impermissible deduction than it would be to take the deduction directly. Thus, the general rule enforced by the IRS is that life insurance premiums are not deductible, nor should tax-deducted funds be used to purchase them.[269]

Second, the Insurance Transaction is also likely to violate the IRS policy against business owners expanding potentially tax-advantaged key man term life insurance into a permanent life insurance policy to accumulate a tax-free investment.[270] Key man life insurance held by a business to protect against the loss of service of a critical employee is a well-established reason to place such insurance, and I.R.C. § 264(e) allows a business to deduct interest on up to

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[266] Zaritsky & Leimberg, *supra* note 24.

[267] Hanlon & Eizenga, *supra* note 200; *Taxes and the Federal Budget Debate*, *supra* note 199.

[268] I.R.C. § 264(a)(1).

[269] *See* I.R.C. §§ 264(a)(1)-(2).

[270] *See generally Neonatology Associates, P.A.*, 115 T.C. at 92 (2000) (reasoning that the contributions were non-deductible to the extent that the contributions "w[ere] to serve as a tax-free savings device for the owner/employees and not, as asserted by petitioners, to provide solely term life insurance to the covered employees").

$50,000 in borrowed funds to pay such key man life insurance policies.[271] However, if the key man justification for the policy is missing, or the purported key man policy is aggressively overfunded beyond an amount that would permit the very limited tax benefit, then the IRS to likely to view such cash value life insurance policies (i.e. whole and variable policies with inside build-up) as tax-avoidant. Of course, where such a policy is purchased by a CIC (as in the Insurance Transaction), it is even more likely to be challenged by the IRS because real insurance companies would not normally purchase such an illiquid investment as personal life insurance—especially a new policy on the common owner of the insured entity and CIC.

Third, the Insurance Transaction is subject to a similar line of generalized attack as was made against the CIC PORC transaction—that the CIC's principal purpose is tax avoidance, not insurance.[272] As in the CIC PORC transactions, the IRS would likely consider, but find the following lacking: (i) the existence of a nontax business purpose for the transaction; (ii) the arms length nature of the transaction (including whether the reserve portfolio was properly diversified); and (iii) the existence of proper risk shifting and distribution.[273]

Finally, the Insurance Transaction is discriminatory to the benefit of the wealthy owners and insiders, due to the high economic barriers required for anyone to participate: (i) high CIC formation and administration costs;[274] (ii) a significant lump sum dividend tax payment due upon distribution of the policy from the CIC; and (iii) the need to leave the policy intact until the insured's death.[275] In each of these cases, a wealthy taxpayer would likely have enough discretionary income to meet these requirements, but a middle class taxpayer would not. The IRS may use this discriminatory tax benefit as a tax policy pretext to attack the Insurance Transaction as an abusive tax shelter.

The Insurance Transaction utilizes small business pre-tax dollars through a CIC that may exclude up to $1.2 million from income[276] to purchase the small business owners' life insurances. The IRS has stated that it would challenge any arrangement that would "divert income properly attributable to the taxpayer to a wholly owned company that is subject to little or no federal income tax."[277] The Insurance Transaction squarely meets this definition. In furtherance of this stated IRS tax policy and all the others referenced above, the IRS is likely to use its expansive enforcement powers to plug the latest hole in the dam separating tax deductions from life insurance premiums.

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271 I.R.C. § 264(e).
272 *See* I.R.S. Notice 2002-70, *supra* note 16.
273 *See id.*
274 Adkisson, *supra* note 18.
275 *See* I.R.C. §§ 72(e)(5)(A), 101.
276 *See* I.R.C. § 831(b).
277 *Id.*; I.R.S. Notice 2002-70, *supra* note 16.