I-COLI: The Genesis of Revenue Procedure 2007-61 and the Future of Insurer-Owned Life Insurance

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On Sept. 11, 2007, the Internal Revenue Service (IRS) took the unusual, but altogether welcome step, of issuing a revenue procedure to overturn a private letter ruling. Revenue Procedure 2007-61, 2007-40 I.R.B. 747, announced a safe harbor rule under which an insurance company may own life insurance policies on its employees—corporate-owned life insurance (COLI) typically held to fund the employer's post-retirement health care liabilities—without forfeiting a portion of its reserve deductions. The private letter ruling (PLR 200738016) had said the contrary, placing insurers at a unique disadvantage *vis-à-vis* banks and other corporations, which can hold COLI on their employees without losing any deductions. The tale of the journey from the adverse private letter ruling to the issuance of the revenue procedure, and some speculation about the future, is the subject of the following discussion.

Background

As part of the Taxpayer Relief Act of 1997 (the 1997 Act), Congress enacted section 264(f)[1] to discourage financial institutions (and others) from purchasing life insurance for their own account on the institutions' customers. The provision did this by denying, in section 264(f)(1), interest deductions in accordance with a "proration" formula if coverage containing "unborrowed cash values" was purchased on the life of an individual other than one in a permitted class, *i.e.*, an officer, employee, director or 20 percent owner of the purchasing entity as described in section 264(f)(4)(A). Under the formula, in very general terms, the otherwise deductible interest is reduced by the ratio of the unborrowed cash values to the average adjusted bases of the taxpayer's overall assets (including the unborrowed cash values). Since banks credit a great deal of interest to depositors and seek to deduct it on their income tax returns, the effect of the provision was precisely what Congress intended: it has limited banks (and like institutions) to purchasing COLI only on members of a section 264(f)(4)(A) permitted class.

At the same time it enacted section 264(f), in the very same section of the 1997 Act, Congress enacted parallel rules for insurance companies.[2] Congress knew that disallowing interest deductions would have only limited effect on insurance companies, which generally do not have large amounts of deductible interest as compared with banks. Hence, in lieu of an interest deduction restriction, Congress imposed rules causing the loss of reserve deductions where the taxpayer is an insurance company subject to taxation under Subchapter L (sections 801-848). *See* section 264(f)(8)(B) (rendering section 264(f) technically inapplicable to insurance companies). Specifically, if a life insurance company holds life insurance policies with unborrowed cash values otherwise described in section 264(f), the amount of the reserve increase or decrease taken into account in computing the company's taxable income is reduced to reflect such unborrowed cash values. *See* sections 807(a)(2)(B)

continued ▸▸16

[1] Unless otherwise indicated, all references to "sections" are to sections of the Internal Revenue Code of 1986, as amended.

[2] *See* section 1084 of the 1997 Act.

from pg. 15

and 807(b)(1)(B). In the case of a property and casualty (non-life) insurance company holding such policies, the amount of the company's losses incurred deduction is reduced. *See* 832(b)(5)(B)(iii). These rules, which state that they apply to "life insurance policies and annuity and endowment contracts to which section 264(f) applies," operate by treating the policies' cash values in the same manner as other tax-favored income items under the proration rules generally applicable to insurers. *See* sections 805(a)(4)(C)(ii), 805(a)(4)(D)(iii), and 805(a)(4)(F) (life insurance companies); section 832(b)(5)(B)(iii) (non-life insurance companies).

The Private Letter Ruling

Significantly, the just-quoted reference to "contracts to which section 264(f) applies" in the Subchapter L rules turned out to be the source of controversy. To date, almost all insurance companies and their tax advisors have read that phrase to encompass life insurance contracts that would have given rise to the interest deduction disallowance under section 264(f) if that provision were applicable to insurers. More particularly, the phrase has been understood to exclude from the proration disallowance rules those contracts that cover permitted classes of insureds—again, contracts that insure officers, employees, directors, and 20 percent owners and, thus, fall within the section 264(f)(4)(A) exception. Such contracts, in other words, are not "contracts to which section 264(f) applies." This interpretation permits insurance companies, like banks and other corporations, to purchase life insurance on their officers, employees and directors without forfeiting income tax deductions otherwise allowable. As a consequence of this interpretation, many insurers have acquired such coverage, which Revenue Procedure 2007-61 dubbed "I-COLI."

A very different view was taken, at least initially, by the IRS National Office. As we reported in the September 2007 issue of *Taxing Times*, a private letter ruling was issued on May 3, 2007, holding that the Subchapter L proration disallowance rules attach whenever an insurance company holds life insurance with unborrowed cash values—regardless of who is insured under them. The ruling effectively denied insurers the same treatment as banks and other corporations, which can purchase life insurance on their officers, employees and directors without losing income tax deductions. The ruling was released to the American Council of Life Insurers (ACLI) by the taxpayer that obtained it. For reasons discussed below in connection with the ruling's reconsideration, the ruling was not released to the public by the IRS after the usual 90-day interval, but instead was released coincident with the issuance of the revenue procedure under the number 200738016.

How did the IRS come to this viewpoint? In reaching its conclusion in the private letter ruling, the IRS reasoned that the pertinent Subchapter L rules referred to "contracts to which section 264(f) applies," not to "contracts to which section 264(f)(1) applies." The absence of the reference to paragraph (1) of subsection (f) in the Subchapter L rules was vital to the IRS's reasoning, particularly in view of the fact that in section 264(f) itself, the section 264(f)(4)(A) exception says that paragraph (1) of section 264(f) will not apply to contracts that qualify for the exception, *i.e.,* contracts covering permitted classes. Section 264(f)(4)(A) does not say that section 264(f) in its entirety does not apply if the exception applies, and yet the Subchapter L rules only speak of contracts to which section 264(f) in its entirety applies. So, in view of the words of these statutory provisions, the IRS adopted this syllogism: (1) the proration disallowance rules in Subchapter L, the counterpart to section 264(f), apply to any contract to which section 264(f) applies; (2) contracts covering permitted classes within the meaning of section 264(f)(4)(A) are excluded from section 264(f)(1), but not from section 264(f) in its entirety; and (3) therefore, all life insurance contracts held by insurance companies are subject to the proration disallowance rules because they are all subject to section 264(f). This reading of the statute, of course, produces a result in stark contrast to banks and other financial institutions, which are not subject to interest expense disallowance in the case of contracts covering permitted classes. Left unexplained by the IRS in PLR 200738016 is why Congress would want to differentiate between insurance companies on the one hand and banks and other financial institutions on the other hand, imposing a far harsher disallowance regime on insurers with respect to life insurance they hold. In the absence of any explanation by Congress, that would seem to be an absurd result.

One might defend the IRS's statutory reading in PLR 200738016 as being a strictly literal reading of the plain words of the statute, but it is questionable whether the IRS actually interpreted the plain words of the statute correctly even from a strictly literal perspective. There is yet a third point of view that could be taken of the critical phrase in the Subchapter L rules, although understanding it may lead to the conclusion that the statutes were not well crafted and thus incapable of a strictly literal interpretation. The third view is that in the

context of the Subchapter L rules, "contracts to which section 264(f) applies" consists of a null set, since according to section 264(f)(8)(B), section 264(f) does not apply to taxpayers subject to Subchapter L. Since section 264(f) does not apply to such taxpayers, it necessarily follows that it cannot apply to any contracts they hold. In other words, the Subchapter L rules are, to recall a term from late in the Nixon Administration, "inoperative," and one reaches the exact opposite conclusion that the IRS reached: viz., *all* contracts held by insurers (not just those covering permitted classes) are exempt from the proration disallowance rules. From a strict statutory construction standpoint, reading the terms as written by Congress most literally, this third interpretation is the correct one. But if "the life of the law has not been logic: it has been experience,"[3] this reading cannot be right, for experience teaches that statutory language is not to be construed as a nullity.

In sum, a strictly literal reading of the plain words of the statute produces two diametrically opposed interpretations, neither of which makes much sense. Manifestly the "plain" words of the statute turn out to be not so plain after all. In such situations, it therefore becomes necessary to consult legislative history and tax policy before reaching a conclusion. The legislative history of the Subchapter L rules is not directly helpful in this exercise, apart from showing that Congress wrote those rules at the same time it wrote section 264(f) and the exception for permitted classes—although the fact that the legislative history definitely does not express any intent on the part of Congress to discriminate against insurers in regard to the ownership of COLI covering only insureds in the permitted classes does weigh against concluding that Congress intended this in drafting the statutory language. Tax policy, on the other hand, should be singularly helpful in the construction of the pertinent rules. From the standpoint of sound tax policy, there is no reason to enable financial institutions (and other types of businesses) generally to hold COLI on their officers, employees, and directors with no tax-based impediment while deploying the tax system to deny this ability to corporations doing an insurance business. Unfortunately, the private letter ruling did not discuss the tax policy considerations, and apparently did not employ them in reaching its conclusion.

The Revenue Procedure

After receiving insurance industry protest against PLR 200738016, particularly from the ACLI, and after considering the matter in conjunction with the Treasury Department, the IRS issued Revenue Procedure 2007-61, effective Sept. 11, 2007. Section 4 of the revenue procedure created a safe harbor, providing that:

> For purposes of applying the insurance company proration rules in §§ 807(a)(2), 807(b)(1), 805(a)(4), 812, or 832(b)(5), an insurance company is not required to take into account any portion of the increase for the taxable year in the policy cash values (within the meaning of section 805(a)(4)) of I-COLI contracts.

Tax policy, on the other hand, should be singularly helpful in the construction of the pertinent rules.

However, as an important constraint on this safe harbor, the revenue procedure extended its relief only to I-COLI contracts "covering no more than 35 percent of the total aggregate number of the individuals described in § 264(f)(4)(A) [*i.e.*, the permitted classes of insureds] at any time during the taxable year." *See* section 3 of Rev. Proc. 2007-61 ("Scope"). At the same time it issued the revenue procedure, the IRS finally released to the public PLR 200738016, which had been circulating informally. However, in consequence of the issuance of the revenue procedure, the IRS also issued PLR 200738017 (Sept. 21, 2007), which modified PLR 200738016 to incorporate the new safe harbor rule.

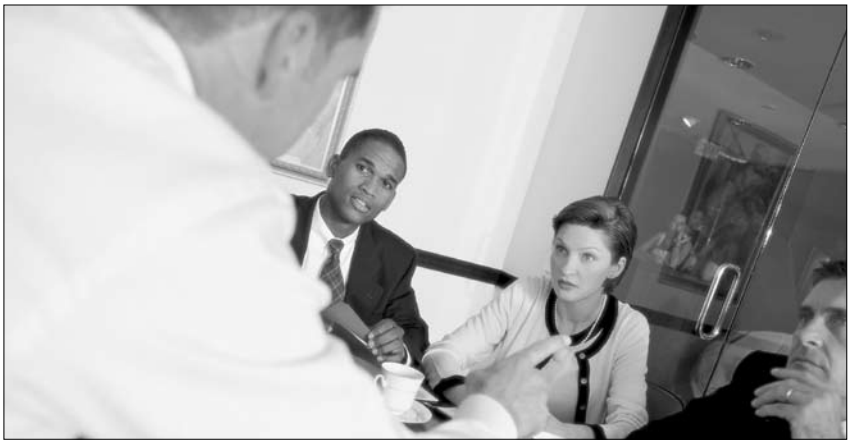
The revenue procedure, in other words, suspended the application of the I-COLI-related Subchapter L proration rules, allowing insurers to hold COLI on permitted classes of insureds in the same manner as other businesses, but it did so only with respect to contracts falling within its 35 percent limitation. While this generally provided good news for insurers, one might ask what is the source and purpose of the 35 percent limitation. The 35-percent-of-permitted-classes limit was *sui*

continued ▸▸ 18

[3] Holmes, Oliver Wendell, Jr., *The Common Law*, at 8 (Mark DeWolfe Howe, ed.) (Back Bay Books, 1963). *The Common Law* was first published in 1880.

from pg. 17

generis in the revenue procedure, as nothing in section 264(f) or the pertinent Subchapter L rules reference any such limit. That said, it should be obvious to anyone knowledgeable of recent legislative developments affecting COLI that the source of the new safe harbor's limit lies in one of the provisions of section 101(j), enacted by the Pension Protection Act of 2006. In particular, by virtue of section 101(j)(2)(A)(ii)(III), the section 101(j)(1) inclusion of death benefits under "employer-owned life insurance" in the employer's taxable income does not apply to coverage on the lives of the top 35 percent of the workforce, determined by compensation and otherwise applying the rules of section 105(h). For this purpose, the top 35 percent is measured by aggregating all employees of the employer and its affiliates. The revenue procedure's 35 percent limit could be invoking a similar rule, by virtue of the aggregation rule found in section 264(f)(8)(A), although the wording of section 3 of the revenue procedure refers only to "35 percent of the total aggregate number of the individuals described in § 264(f)(4)(A)."



Regardless of the scope of the new 35 percent limit, it remains to consider why the revenue procedure imposed it when the Subchapter L rules (and section 264(f) itself) are silent in this respect. The revenue procedure is equally silent on the purpose of imposing the limit, but one might infer one or both of two possible purposes behind its imposition. One would be a desire to parallel the latest thinking of Congress of the permissible reach of broad-based COLI arrangements. If so, then resort to some sort of 35 percent limit might be appealing from a tax policy standpoint. Another possibility would lie in a need, in granting a "safe harbor," to condition the favorable treatment granted by the revenue procedure on compliance with some external constraint. If this were not done, then the IRS could be seen as simply "giving up" on the position taken in PLR 200738016, a step eschewed by the drafters of the revenue procedure (see section 2.02, third sentence, of the revenue procedure).

The 35 percent limitation aside, Revenue Procedure 2007-61 provided more good news, and some other news, too. Section 4 of the revenue procedure provided that its safe harbor applies "pending the publication of additional guidance," and section 5 thereof went on to state that additional guidance, if any, published interpreting the phrase "contracts to which section 264(f) applies" will apply prospectively. As for the other news, the revenue procedure states that I-COLI contracts will "remain subject to challenge under other provisions of the tax law, including judicial doctrines such as the business purpose doctrine."

In section 6 of the revenue procedure, the IRS requested comments by Dec. 31, 2007, on "the need for additional guidance in this area." Going beyond the issue of the proper construction of the Subchapter L rules, and likely relating back to the just-quoted statement that I-COLI contracts will remain subject to challenge under other provisions of the tax law, the IRS specifically asked for comments regarding the "existence of any non-tax regulatory rules or other requirements that limit an insurance company's ability to invest in I-COLI contracts and the effect of any experience rating, inter-insurance, reciprocal or reinsurance arrangement on transactions involving I-COLI contracts." "In addition," said the revenue procedure, "the IRS would welcome comments on the operation of arrangements involving I-COLI contracts."

Thoughts for the Future

Whenever information is requested by a government agency, it is incumbent upon those receiving the request—or at least those most likely expected to respond to the request—to evaluate carefully the advisability of replying along with the content of their reply. That said, it is fairly obvious from the questions being asked by the IRS in section 6 of the revenue procedure that the IRS (and the Treasury Department) is serious about examining the treatment of I-COLI under the tax law. Hence, while no reply is mandated, seemingly it would be a good idea for the holders and the sellers of I-COLI to provide one. It is unlikely that the questions will be resolved on their own or simply disappear, and if those interested in and knowledgeable of I-COLI arrangements do not respond to the request for information, there is no guarantee that the questions will be answered appropriately. The authors anticipate that a response to

one or more of the questions will be forthcoming from the ACLI, which worked successfully to have the revenue procedure issued, as well as from the Committee on Insurance Companies of the American Bar Association's Section of Taxation. It also would be proper for insurers, whether as holders or as sellers of I-COLI, to consider offering the input requested, for questions not satisfactorily answered in the short run may well appear again in the next audit cycle.

So, if the questions listed in Revenue Procedure 2007-61 are to be answered, which questions should receive the responders' main attention? First of all, it may be instructive that the request for additional information or argument on the construction of the pertinent Subchapter L rules (or section 264(f), for that matter) did not even make the list. Indeed, in its section 5, the revenue procedure recites that it will make any change in the interpretation of the Subchapter L rules prospective "[i]f, in response to comments, additional guidance is published interpreting the phrase 'contracts to which section 264(f) applies'." In other words, there may be no further guidance on the point. Diminution of any lingering concern over the interpretation of the Subchapter L rules would be consistent with, and explained by, the express view of the Bush Administration that businesses operating in one type of industry (*e.g.,* insurance companies) should not be treated any more or less favorably under the tax law than those operating in another type of industry (*e.g.,* banks). This view can be seen as the driving force behind the Treasury Department's role in the (relatively) prompt issuance of the revenue procedure following the release of the contrary private letter ruling to the ACLI. It likewise is particularly on point when the businesses involved may properly be considered to operate within the very same industry (*i.e.,* financial services). All of this said, it is possible that some continuing concern remains over the proper construction of the Subchapter L rules, as witnessed in the last sentence of section 6.01 of the revenue procedure, *i.e.*, in the statement indicating that "[i]n addition" the IRS "would welcome comments on the operation" of I-COLI. Whether or not the construction of the tax law's rules is central to the revenue procedure's information requests, the fact remains that it is the subject of the safe harbor, and hence the arguments in favor of the more sensible reading of the applicable rules should be recorded, forcefully, in the responses to the questions.

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Taking section 6.01 of the revenue procedure at face value, it is likely that the IRS and the Treasury Department are most interested in receiving comments on the first set of topics listed in that section: the effect of any experience rating, inter-insurance, reciprocal or reinsurance arrangement on I-COLI transactions. This request covers a good deal of ground, and it treads on some issues that are not simple to discuss, so that answering the request will necessitate careful planning on the part of those responding. Experience rating, the first topic mentioned in the revenue procedure's list, is a widely used feature in broad-based COLI cases, including I-COLI, and one that is based in long-standing insurance industry practice and acknowledged in the rules of the tax law. It also has attracted some attention, and controversy, by virtue of the litigation on leveraged COLI, in which the use of "100 percent experience rating" led the courts to question whether the COLI contracts involved the presence of insurance risk at all.[4] In addition, the Emerging Issues Task Force of the Financial Accounting Standards Board has raised its own questions about the effect of experience rating on COLI and other group insurance arrangements, even going so far as to propose radical changes in the GAAP accounting for such arrangements. At base, the question here is a central one to the existence of insurance, for it asks whether risk has been shifted away from the policyholder in a meaningful way under a COLI arrangement. Accordingly, any response on this topic will need to recognize and explain the authorities

continued ▸▸20

[4] American Electric Power, Inc., v. United States, 136 F. Supp. 2d 762 (S.D. Ohio 2001), *aff'd* 326 F.3d 737 (6th Cir. 2003), *cert. denied,* 540 U.S. 1104 (2004); In re C.M. Holdings, Inc., 254 B.R. 578 (D. Del. 2000), *aff'd* 301 F.3d 96 (3d Cir. 2002); Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11th Cir. 2001), *cert. denied,* 535 U.S. 986 (2002). *See also* Dow Chemical Company and Subsidiaries v. United States, 250 F. Supp. 2d 748, *modified* 278 F. Supp. 2d 844 (E.D. Mich. 2003), *rev'd* 435 F.3d 594 (6th Cir. 2006), *cert. denied,* 127 S.Ct. 1251 (2007). It should be noted that the issue in these cases was the deductibility under section 163 of interest on the COLI contract loans. The government did not directly challenge the status of the corporate-owned life insurance contracts as insurance on account of experience rating; rather, the government argued that the lack of insurance risk indicated that the COLI contract loan transactions lacked economic substance.

from pg. 19

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to date, distinguishing the good from the questionable, and in some fashion come to grips with the difficult issue of defining when and how the shifting of insurance risk is adequate or meaningful.[5]

The remaining topics in the list—inter-insurance, reciprocal or reinsurance arrangements that have an effect on I-COLI transactions—present equally significant issues that are not simple to discuss in a response to the IRS. Interestingly, in the COLI context, this group of issues smacks of captive insurance concerns. In the litigation and ruling activity involving so-called captive insurers, for example, reinsurance played a large role in returning to the policyholder the losses from insurance risks that initially were transferred to a third-party insurer.[6] It therefore is not surprising that the IRS is raising the point again in the context of I-COLI, as it continues to do in circumstances involving captive insurance arrangements even though it abandoned its earlier "economic family" approach to the captive issue. Reminiscent of the IRS's current approach in the captive insurance area, the safe harbor rule in section 4 of the revenue procedure recites that I-COLI contracts will "remain subject to challenge under other provisions of the tax law, including judicial doctrines such as the business purpose doctrine." [7]

For now, however, it seems that the revenue procedure has granted insurance companies a large measure of comfort that the I-COLI they are holding, covering only insureds in the permitted classes under section 264(f)(4)(A) and hopefully fitting within the revenue procedure's 35 percent limit, does not diminish their otherwise allowable reserve deductions. Today, in the context of GAAP guidance such as FIN 48, requiring a "more likely than not" conclusion that claimed tax benefits will be realized before they can be recognized for financial accounting purposes, such comfort clearly is needed. On the other hand, issues associated with I-COLI cannot be viewed as having been put to rest. The insurance industry may therefore find it beneficial to take this opportunity to respond to the IRS's request for comments in section 6 of the revenue procedure.

[5] *See* Kirk Van Brunt, *Experience Rating, Helvering vs. Le Gierse, and COLI/BOLI Arrangements, Taxing Times*, Vol. 1, Issue 3, at 19 (Dec. 2005).

[6] *See* Rev. Rul. 77-316, 1977-2 C.B. 53, *obsoleted by* Rev. Rul. 2001-31, 2001-1 C.B. 1348.

[7] *See* Rev. Rul. 2001-31, *supra* note 6.