I.D.3. Abusive Transactions Not Listed

Introduction

In addition to known abusive tax shelters identified as listed transactions, there is also a category of transactions that exhibit elements of abusive transactions, but have not officially been identified as listed transactions. As these transactions come to light, OTSA closely monitors them and studies their characteristics. If OTSA determines that any of these show potential for classification as a listed transaction, OTSA will forward them to Chief Counsel and Treasury for further consideration. Chief Counsel andTreasury makes the final determination regarding whether the transactions are sufficiently abusive to be elevated to the status of listed transactions. An example of a transaction exhibiting characteristics of an abusive tax shelter that has not been officially identified as a listed transaction is the Corporate Owned Life Insurance (COLI) transaction. The reason COLI is not officially classified as a listed transaction is that the issue was uncovered long before OTSA was established and before the Service started "listing" the abusive transactions. The Service, has, however, accorded COLI transactions the same treatment as the listed transactions.

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COLI

In general, Corporate Owned Life Insurance (COLI) is a series of life insurance policies purchased by a corporation on the lives of some or all of its employees. The corporation, not the employee, is the beneficiary under these policies. The COLI issue addressed broad-based (i.e. large numbers of insured employees) highly leveraged COLI plans that exploit the tax arbitrage opportunities inherent in COLI policies. Through the use of large policy loans in the first three plan years, large interest deductions are generated from the policy loans beginning in year one. The tax benefits from these interest deductions, coupled with tax free mortality benefits, result in the COLI plans producing positive cash flows and earnings on an annual basis and over the life of the plans.

Because COLI plans are fueled by the predictable tax benefits gained through manufactured interest deductions, the annual cash flows and earnings are generally negative, absent the tax savings. Only on a post-tax basis do the cash flows and earnings become positive as a direct result of the tax savings generated by the interest deductions.

It is the Service's position that the transactions underlying the interest deductions are shams and therefore should not be respected for tax purposes. The Courts have uniformly sustained the Service's disallowance of COLI interest deductions, holding that the COLI policies lacked economic substance and therefore were economic shams. The Service has also successfully argued in litigation that the COLI plans violated the seven year level premium requirement of IRC § 264(d)(1).

(ALL REVENUE AGENTS WITH **COLI** TRANSACTIONS ARE REQUIRED TO CONTACT THE TECHNICAL ADVISOR GEORGE IMWALLE)

Case Law References

Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001) aff'g 113 T.C. 254 (1999).

IRS v. C.M. Holdings, Inc., (in re CM Holdings, Inc.), 2002 U.S. App. LEXIS 17171 (3d Cir. 2002), aff'g . 254 B.R. 578, 2000-2 U.S. Tax Cas. (CCH) P50, 791 (D. Del2000).

American Electric Power v. United States, 136 F. Supp. 2d 762 (S.D. Ohio 2001).

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I.D.3. Abusive Transactions Not Listed, Continued

Emerging Issues	As new emerging issues are detected, they will be posted on OTSA's intranet site.
Contact Technical Advisors and Division Counsel	The transaction summarized above is quite complex and may involve a multitude of legal issues, including the business purpose and economic substance doctrines. Issues involved in these doctrines require extensive time and knowledge for proper development. Therefore, when revenue agents suspect that they have found a tax shelter, they should contact the Technical Advisor assigned to that transaction for assistance. In addition, they should involve counsel early in the development process. Both of these resources will serve to reduce audit time and lead to a well-developed issue.