No. 03-529

In the Supreme Court of the United States

AMERICAN ELECTRIC POWER COMPANY, INC., ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether interest expenses claimed in connection with a corporate-owned life insurance program may be deducted when that program lacked any economic substance or business purpose and was created solely for the purpose of generating artificial tax deductions.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a)[1] is reported at 326 F.3d 737. The opinion of the district court (Pet. App. 20a-88a) is reported at 136 F. Supp. 2d 762.

JURISDICTION

The judgment of the court of appeals was entered on April 28, 2003. The petition for rehearing was denied on July 9, 2003. Pet. App. 90a. The petition for writ of

[1] The concurring opinion initially issued by Judge Nelson (Pet. App. 16a-19a) was withdrawn in the order denying the petition for rehearing (*id.* at 90a).

certiorari was filed on October 6, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner American Electric Power Company, Inc. is a public utility holding company based in Columbus, Ohio. Petitioner owns various operating, service, and coal-producing subsidiaries that conduct business in seven states. Pet. App. 21a.

2. Corporate-owned life insurance (COLI) is life insurance purchased by a corporate employer to insure the life of one or more employees. The employer ordinarily owns the policy, pays the premiums and is the policy beneficiary. Such policies traditionally were written to protect a corporation from financial loss resulting from the death of a key person. In 1986, to limit the use of such policies in tax avoidance schemes, Congress disallowed any interest deduction attributable to a loan in excess of $50,000 made in connection with a COLI policy. 26 U.S.C. 264(a)(4) (1994). Following enactment of that provision, a new type of COLI product—known as "broad-based" COLI—evolved. Department of Treasury, *Report to the Congress on the Taxation of Life Insurance Company Products* 14 (Mar. 1990). Under a "broad-based" COLI program, a corporation purchases policies on the lives of numerous or all of its employees. *Ibid.*

In 1990, petitioner purchased a broad-based COLI program offered by Mutual Benefit Life Insurance Company. Pet. App. 2a. Under the program, petitioner took out life insurance policies on the lives of more than 20,000 of its employees. Those policies were to remain in effect even after the individuals left petitioner's employment. Petitioner was, at all times, the sole beneficiary of the policies. The annual premium was $16,667 per employee, and the amount of the death benefit varied depending on the age of the insured. *Id.* at 2a, 41a.

The COLI plan allowed petitioner to select the interest rate to be charged on policy loans from a menu of options. The plan further provided that the insurance company was to credit the interest charged on the loans, less a fixed one-percent differential, back to petitioner in the form of interest on the policy value. The effect of this plan provision was that petitioner actually paid only a small fraction of the stated interest expenses–expenses that it subsequently claimed as a deduction on its tax return. And, in an effort to maximize these stated interest expenses and the resulting claimed interest expense deductions, petitioner consistently picked one of the highest rates on the plan menu. Pet. App. 4a. The selection of a high interest rate did not actually increase the amount of petitioner's actual out-of-pocket interest expenses, since petitioner paid only the one-percent differential between the interest shown on its policy loans and the interest added to the policy values. *Id.* at 4a, 42a, 78a.

The COLI plan was designed to be "mortality neutral" and to operate with "zero net equity." Pet. App. 8a. Mortality neutrality meant that neither petitioner nor the insurance company could expect to profit over the life of the plan from the deaths of insured individuals. *Id.* at 3a-4a. That "neutrality" was achieved by (i) increasing the insurance charges when mortality experience favored petitioner and (ii) increasing the payment of mortality benefits to petitioner when experience favored the insurer. *Ibid.*

The net equity of the COLI plan—also known as its cash surrender value—was the policy value less outstanding policy loans and accrued interest. Pet. App.

3a. Through a series of simultaneous netting transactions, petitioner was able to limit the cash paid at the beginning of each policy year to the precise amount of its annual cost-of-insurance charges, loan interest spread and policy expenses. *Id.* at 79a. As a result, at the end of each policy year, petitioner's COLI plan had a net equity of zero. *Id.* at 3a.

The financial projections provided to petitioner before it purchased the COLI program demonstrated how the plan was expected to perform. Pet. App. 43a. These projections showed that, without taking purported tax benefits into account, the cash flow would be negative in every year and, at the end of 20 years, the cumulative deficit would be more than $268 million. *Id.* at 70a. These projections further showed that, if the entire amount of the asserted policy loan interest expenses were treated as tax deductions, petitioner would obtain tax savings of more than $820 million—an amount that would more than offset the actual negative cash flow from the COLI transactions. *Ibid.*

3. On their consolidated income tax return for 1996, petitioner and its affiliates claimed policy loan interest expense deductions in excess of $66 million. The Internal Revenue Service disallowed the claimed deductions and determined a tax deficiency of more than $25 million. Pet. App. 21a. Petitioner paid the tax and filed this refund suit in federal district court.

Following a six-week bench trial, the district court granted judgment in favor of the government. The court upheld the denial of the claimed interest deductions because the COLI plan was an economic sham. Pet. App. 66a-73a. In reaching that conclusion, the court stressed that the economic projections provided to petitioner before it purchased the plan showed that "[w]ithout the policy loan interest deductions, the

* * * COLI * * * plan would have been a financial disaster," for it would have resulted in a negative cash flow in every year and a cumulative negative cash flow in excess of $268 million. *Id.* at 70a. The court "search[ed] the transaction to determine whether it ha[d] any practical or economic effects, other than the creation of income tax losses." *Ibid.* The court found that, because petitioner's COLI plan was designed to be mortality neutral and have zero net equity, it lacked the two primary characteristics of whole life insurance. *Id.* at 70a-71a. As a consequence, the "COLI plan did not appreciably affect [petitioner's] beneficial interest except to reduce its tax." *Id.* at 71a.

The court found that "the opportunity for tax arbitrage * * * was the real motivation for [petitioner's] purchase of the COLI policies." Pet. App. 68a. The court rejected petitioner's assertion that this transaction should be treated as if it had a valid business purpose because the tax savings sought by petitioner would have benefitted its balance sheet. *Id.* at 79a-80a. The court explained that, "[i]f a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose is to reduce taxes, [then] every sham tax-shelter device might succeed.'" *Id.* at 80a (quoting *Winn-Dixie Stores, Inc.* v. *Commissioner*, 113 T.C. 254, 287 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002)).

The district court held, in the alternative, that the policy interest expense deductions claimed by petitioner were disallowed by Section 264(a)(3) of the Internal Revenue Code, 26 U.S.C. 264(a)(3). Pet. App. 87a. The court rejected petitioner's assertion that an exception in Section 264(c)(1) of the Code, 26 U.S.C. 264(c)(1), justified the claimed deductions. Pet. App.

86a-87a. The court noted that this statutory exception requires that the premiums be level during the first seven year period of the plan and that, since the premium charges were both varying and based upon factual shams, petitioner could not qualify for the exception. *Id.* at 63a, 87a.

The district court also adopted additional alternative grounds for denying the asserted interest expense deductions. The court held that: (i) the interest rate component of petitioner's COLI plan lacked economic substance (Pet. App. 76a-78a), (ii) the purported interest obligation claimed for the initial period for which the policies had been backdated was a factual sham (*id.* at 56a-58a); and (iii) a $26 million "dividend" added to the first year policy values was a factual sham (*id.* at 63a).

4. The court of appeals affirmed. Pet. App. 1a-15a. The court held that "[t]he controlling question * * * is whether there is anything of 'substance to be realized by [the taxpayer] from [a] transaction beyond a tax deduction.'" *Id.* at 12a (quoting *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960)). The court explained that the "proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses" and that "[a] taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant in this inquiry." Pet. App. 6a (quoting *Rose* v. *Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989)).

Applying this standard, the court concluded that petitioner's "COLI plan * * * bears the hallmarks of an economic sham." Pet. App. 8a. The court pointed out that, because the plan was structured to have mortality neutrality and zero net equity, it did not provide the essential non-tax benefits that insurance plans characteristically offer. *Ibid.* The court concurred in the finding of the district court that this transaction lacked any valid business purpose and that the desire to engage in a tax shelter scheme was the only real motivation for petitioner's participation in this COLI plan. *Id.* at 8a. In concluding that this tax avoidance scheme was an economic sham, the court noted that the same conclusion had been reached in other, similar COLI cases recently decided by other courts of appeals. *Id.* at 13a (citing *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002); *Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002)).

ARGUMENT

The factual determination of the courts below that petitioner's COLI program had no practical economic effect other than generating tax deductions has ample support in the record. The holding of the court of appeals that the claimed interest deductions are therefore not allowable correctly applies the decisions of this Court and does not conflict with the decision of any other court of appeals.

Indeed, this Court previously declined to review the decision of the Eleventh Circuit disallowing claimed interest expense deductions in *Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002), which involved a COLI plan that was indistinguishable in effect from the plan involved in this case. Pet. App. 13a. See also *In re CM Holdings, Inc.*, 301 F.3d 96, 101-102 (3d Cir. 2002) (holding that a broad-based COLI program is an economic sham). For the reasons stated in detail in our brief in opposition to the petition in *Winn-Dixie*, there is no conflict among the circuits on the issues presented in this case and further review is therefore not warranted.[2]

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[2] A copy of the government's brief in opposition in *Winn-Dixie* is provided herewith to petitioner. The two claims raised in this case that were not raised in *Winn-Dixie* are both insubstantial. First, petitioner claims (Pet. 17) that a statement in a 32-year-old brief in opposition filed by the government in *Golsen* v. *Commissioner*, 404 U.S. 940 (1971) (No. 71-368), stands for the proposition that the government believes that the economic substance doctrine no longer applies to COLI transactions after the enactment of Section 264 of the Code. As the decisions cited by the courts below reflect, that assertion is frivolous, for the government has routinely challenged COLI transactions that lack economic substance. See Pet. App. 13a. The 1971 brief in opposition in *Golsen* states only that, in light of the then-recent enactment of Section 264, there was no need for the Court to review a fact-intensive conflict among decisions that had applied the economic substance doctrine prior to the enactment of that statute. Br. in Opp. at 6. The brief noted that such a fact-intensive conflict lacked recurring importance because few "similar cases" then existed that involved transactions predating the enactment of that statute. *Ibid.*

Second, petitioner incorrectly claims that the decision in this case conflicts with *Shirar* v. *Commissioner*, 916 F.2d 1414 (9th Cir. 1990). *Shirar* was not a COLI case; it involved an individual who purchased insurance under an arrangement that provided him "with a substantial return for his out-of-pocket costs." *Id.* at 1418. By contrast, the COLI plan involved in the present case was predetermined to result in hundreds of millions of dollars of built-in losses and could *not* have generated any positive "return" on out-of-pocket costs. Pet. App. 70a.

Petitioner also errs in broadly asserting that the decision in this case conflicts with a variety of other, unrelated decisions. The decisions cited by petitioner concern radically different facts and address wholly distinct legal questions (Pet. 24-27 (citing *Cottage Savings Ass'n* v. *Commissioner*, 499 U.S. 554 (1991) (concerning the deductibility of a loss incurred upon the sale or exchange of mortgage securities); *United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725 (1977) (concerning the proper allocation of unearned pre-

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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mium reserves of casualty insurance policies); *Sears, Roebuck & Co.* v. *Commissioner*, 972 F.2d 858 (7th Cir. 1992) (concerning the deductibility of insurance premiums paid to a subsidiary insurance company)).