Part III - Administrative, Procedural, and Miscellaneous

Certain Reinsurance Arrangements

Notice 2002-70

The Internal Revenue Service and Treasury Department have become aware of a type of transaction, described below, that is being used by taxpayers to shift income from taxpayers to related companies purported to be insurance companies that are subject to little or no U.S. federal income tax. This notice alerts taxpayers and their representatives that these transactions often do not generate the federal tax benefits that taxpayers claim are allowable for federal income tax purposes. This notice also alerts taxpayers, their representatives, and promoters of these transactions, to certain reporting and record keeping obligations and penalties that they may be subject to with respect to these transactions.

The transaction generally involves a taxpayer ("Taxpayer") (typically a service provider, automobile dealer, lender, or retailer) that offers its customers the opportunity to purchase an insurance contract through Taxpayer in connection with the products or services being sold. The insurance provides coverage for repair or replacement costs if the product breaks down or is lost, stolen, or damaged, or coverage for the customer's payment obligations in case the customer dies, or becomes disabled or unemployed.

Taxpayer offers the insurance to its customers by acting as an insurance agent for an unrelated insurance company ("Company X"). Taxpayer receives a sales commission from Company X equal to a percentage of the premiums paid by Taxpayer's customers. Taxpayer forms a wholly-owned corporation ("Company Y"), typically in a foreign country, to reinsure the policies sold by Taxpayer. Promoters sometimes refer to these companies as producer owned reinsurance companies or "PORCs". If Company Y is a foreign corporation, it typically elects to be treated as a domestic insurance company under § 953(d) of the Internal Revenue Code. Company Y takes the position that it is entitled to the

benefits of § 501(c)(15) (providing that non-life insurance companies are tax exempt if premiums written for the taxable year do not exceed $350,000), § 806 (providing a deduction for certain life insurance companies with life insurance company taxable income not in excess of $15,000,000), or § 831(b) (allowing qualifying non-life insurance companies whose net written premiums are between $350,000 and $1,200,000 to elect to be taxed solely on investment income).

Taxpayer receives premiums from its customers and remits those premiums (typically net of its sales commission) to Company X. Company X pays any claims and state premium taxes due and retains an amount from the premiums received from Taxpayer. Under Company Y's reinsurance agreement with Company X, Company Y reinsures all insurance policies that Taxpayer sells to its customers. Company X transfers the remainder of the premiums to Company Y as reinsurance premiums.

ANALYSIS

Many of the transactions described in this Notice have been designed to use a reinsurance arrangement to divert income properly attributable to Taxpayer to Company Y, Taxpayer's wholly-owned reinsurance company that is subject to little or no federal income tax. The Service intends to challenge the purported tax benefits from these transactions on a number of grounds.

First, depending upon the facts and circumstances, the Service may assert that Company Y is not an insurance company for federal income tax purposes. For federal income tax purposes, an insurance company is a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

§ 1.801-3(a) of the Income Tax Regulations; § 816(a) (which provides that a company will be treated as an insurance company for federal income tax purposes only if "more than half of the business" of that company is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies). While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972) (taxpayer whose predominant source of income was from investments did not qualify as an insurance company); see also Bowers v.

Lawyers Mortgage Co., 285 U.S. 182, 188 (1932). To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Indus. Life Ins. Co. v. United States, 344 F. Supp. 870, 877 (D. S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973). To determine whether Company Y qualifies as an insurance company, all of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether Company Y engages in other trades or businesses, and its sources of income. See generally Lawyers Mortgage Co. at 188-90; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 425 F. 2d 1328 (5th Cir. 1970); Serv. Life Ins. Co. v. United States, 189 F. Supp. 282, 285-86 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-Am. Life Ins. Co., at 506-08 ; Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933).

If Company Y is not an insurance company, it is not entitled to the benefits of §§ 501(c)(15), 806, or 831(b). Further, if Company Y is a foreign corporation and is not an insurance company, any election Company Y made under § 953(d) is not valid and Company Y will be treated as a controlled foreign corporation as defined in § 957. In such a case, Taxpayer will be treated as a U.S. shareholder of Company Y and generally will include in its gross income on a current basis any subpart F income of Company Y. See § 951(a) and (b). In addition, Company Y will not qualify for the exceptions from subpart F income under §§ 953(a)(2) and 954(i) for certain insurance income because those exceptions are only available to a foreign corporation that, among other requirements, is engaged in the insurance business and would be subject to tax under subchapter L if such corporation were a domestic corporation. See § 953(e)(3)(C).

Second, the Service may apply §§ 482 or 845 to allocate income from Company Y to Taxpayer if necessary clearly to reflect the income of Taxpayer and Company Y. Section 482 provides the Secretary with authority to allocate gross income, deductions, credits or allowances among persons owned or controlled directly or indirectly by the same interests, if such allocation is necessary to prevent evasion of taxes or clearly to reflect income. The § 482 regulations provide that in determining the taxable income of a controlled person, the standard to be applied is that of a person dealing at arm's length with an

uncontrolled person. § 1.482-1(b)(1). Section 482 may apply to a transaction between two or more controlled persons notwithstanding that an uncontrolled person participates in the transaction as an intermediary. See GAC Produce Co. v. Commissioner, T.C.M. 1999-134. If, as a result of the reinsurance transaction, Taxpayer's income is not consistent with the arm's length standard, then § 482 authorizes the Secretary to allocate income from Company Y to Taxpayer. Section 845(a) allows the Service to reallocate income, deductions, assets, reserves, credits, and other items between two or more related parties who are parties to a reinsurance agreement. Thus, such items may be reallocated from Company Y to Taxpayer under the authority of § 845(a).

Third, in appropriate cases, the Service may disregard the insurance and reinsurance arrangements, and thereby require Taxpayer to recognize an additional portion of premiums received from its customers as its income, if the arrangements are shams in fact or shams in substance. See Kirchman v. Commissioner, 862 F.2d 1486, 1492 (11th Cir. 1989). Courts have distinguished between "shams in fact" where the reported transactions never occurred and "shams in substance" which actually occurred but lack the substance their form represents. ACM Partnership v. Commissioner, 157 F.3d 231, 247 n. 30 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (2002) (citations omitted). In determining whether a transaction constitutes a sham in substance, both a majority of the Courts of Appeals and the Tax Court consider two related factors, economic substance apart from tax consequences, and business purpose. See ACM Partnership; Karr v. Commissioner, 924 F.2d 1018, 1023 (11th Cir. 1991), cert. denied, 502 U.S. 1082 (1992); James v. Commissioner, 899 F.2d 905, 908-09 (10th Cir. 1990); Shriver v. Commissioner, 899 F.2d 724, 727 (8th Cir. 1990); Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989); Kirchman. Although a taxpayer has the right to arrange its affairs to reduce its tax liability, the substance of a transaction must govern its tax consequences regardless of the form in which the transaction is cast. See Gregory v. Helvering, 293 U.S. 465, 469 (1935). If the transactions involving Taxpayer, Company X, and Company Y are disregarded, the income of Company Y is income of Taxpayer. See Wright v. Commissioner, T.C.M. 1993-328.

Transactions that are the same as, or substantially similar to, the transaction described in this Notice that involve taxpayers claiming entitlement to the benefits of §§ 501(c)(15), 806, or 831(b) are

identified as “listed transactions” for purposes of § 1.6011-4T(b)(2) of the temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the temporary Procedure and Administration Regulations. See also § 301.6112-1T, A-4. Independent of their classification as “listed transactions” for purposes of §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111, or the list maintenance requirements of § 6112 (§§ 1.6011-4T, 301.6111-1T, 301.6111-2T and 301.6112-1T, A-3 and A-4).

Persons who are required to satisfy the registration requirement of § 6111 with respect to the transactions described in this Notice and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transactions described in this notice and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in these transactions or substantially similar transactions involving taxpayers claiming entitlement to the benefits of §§ 501(c)(15), 806, or 831(b) or, as applicable, on persons who participate in the promotion or reporting of such transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

The principal authors of this Notice are John Glover of the Office of Associate Chief Counsel (Financial Institutions and Products) and Theodore Setzer and Sheila Ramaswamy of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Mr. Glover at (202) 622 -3970 or Mr. Setzer or Ms. Ramaswamy (202) 622-3870 (not a toll-free call).