Chapter 8
PORC

Introduction

In today's business climate, it is not unusual to find that producers (e.g. service providers, lenders, retailers) offer customers the option of purchasing insurance products such as extended service contracts, credit life insurance, involuntary unemployment insurance, and property insurance. In some cases the reinsurance company is owned by the producing company. In others, it is owned by shareholders of the producer, e.g. auto dealerships. Even though the reinsurance company may not actually be owned by the "producer" of the insurance business, but rather by shareholders of the producer, the company is often referred to as a Producer Owned Reinsurance Company or PORC.

PORCs may be associated with a variety of producers including, but not limited to, auto dealerships, furniture stores, rent-to-own stores, electronics stores, credit card companies, and lending institutions. Products reinsured into the PORC can include extended service contracts, credit life and disability insurance, theft and property damage insurance, credit card and loan default insurance, and involuntary unemployment insurance.

The PORC is generally part of a closely held group of companies and is frequently formed in an off-shore domicile with minimal capitalization requirements and regulatory oversight. Although formed off-shore, the PORC typically makes a Section 953(d) election to be treated for tax purposes as a U.S. corporation and to take advantage of favorable U.S. insurance company tax laws. Depending upon the type of business reinsured, the company may be subject to IRC Section 806 for life insurance companies, IRC Section 501(c)(15) for insurance companies that are not life insurance companies and that have premiums less than $350,000, or IRC Section 831(b) which enables insurance companies that are not life insurance companies and with premiums between $350,000 and $1.2 Million to elect to be taxed only on investment income. In April, the President signed H.R. 3108, Pension Funding Equity Act of 2003, that contains revisions to IRC Section 501(c)(15) effective for tax years beginning after December 31, 2003. The Act contains a "Change in Income" test. For stock companies, the premium income test ($350,000) has been replaced with a gross receipts test raised to $600,000, half of which (or more) must be premium income. An Insurance Business Activity Test is also imposed. By using the life insurance company definition in IRC 816(a) as the definition of insurance, a business activity test has been imposed (at least 50% of the business must be insurance issuance business).

It is important to note that not all PORCs are abusive. However, due to the nature of the company and the favorable insurance tax provisions, the entities are inherently abusible. In order to address the potential abusive use of PORCs, the Service issued Notice 2002-70, 2002-44 I.R.B. 765 (November 4, 2002) .

PORC as a Listed Transaction – Notice 2002-70

Issued in November of 2002, the Notice notified taxpayers that the Internal Revenue Service and Treasury Department had become aware of a type of transaction 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. The 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. The 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 Notice describes the transaction as one that "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."

The Notice advises taxpayers that many of the transactions described in the Notice have been designed to use a reinsurance arrangement to divert income properly attributable to a taxpayer to a related reinsurance company that is subject to little or no federal income tax. Finally, the Notice notifies taxpayers that the Service intends to challenge the purported tax benefits from these transactions on a number of grounds..

The Notice sets forth three arguments the Service may use to challenge the purported tax benefits from these transactions.

1. First – that the PORC entity is not an insurance company if it does not have as its primary and predominant business activity the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

2. Second – if the pricing is not at arm's length, then the parties have failed to properly allocate income, deductions and other items between the taxpayer and its reinsurance company. Under this theory, additional income would be allocated to the taxpayer. See GAC Produce Co. v. Comm'r., T.C.M. 1999-134.

3. Third – looks to whether the transaction is a sham. In appropriate cases, the IRS 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. Comm'r., 862 F.2d 1486, 1492 (11th Cir. 1989).

Transactions that are the same as, or substantially similar to, the transaction described in the Notice that involve taxpayers claiming entitlement to the benefits of I.R.C. §§ 501(c)(15), 806, or 831(b) are identified as "listed transactions." The Notice informs taxpayers that the Service may impose penalties on participants in these transactions or substantially similar transactions involving taxpayers claiming entitlement to the benefits of Sections 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.

Designating a transaction as a listed transaction imposes certain disclosure obligations on taxpayers under Procedure and Administration Regulation section 1.6011-4. Taxpayers that participate in a listed transaction are required to attach a statement disclosing such participation to each tax return covering a year in which they participated in the transaction. A copy of the disclosure statement must be filed with the Office of Tax Shelter Analysis (OTSA) for the first year of participation. For taxpayers that participated in a transaction which subsequently became listed, a copy of the disclosure statement should be filed with OTSA for the first tax year ending after the date the transaction was designated as a listed transaction.

PORC Formation

In the 1970s, insurers began offering reinsurance programs to large producers using U.S. based PORCs for life and disability reinsurance programs, but these PORCs needed substantial capitalization and were heavily regulated. In the late 1970s and 1980s, offshore PORCs began to appear and soon became popular because they were more flexible in terms of coverage they could write and because the levels of capitalization were lower, thus allowing more moderately sized producers to establish a PORC.

The formation of a PORC involves consideration of several factors. Some of the more important factors include: formation costs, capital requirements, investment restrictions, taxes, reporting, security of assets and overall regulatory environment.

Today, many controlled PORCs are incorporated in foreign jurisdictions. Offshore PORCs are typically more attractive to companies because they offer minimal capitalization requirements and a relaxed regulatory environment. Formation can be accomplished in a shorter period of time and the cost of operation is modest. Many offshore locations allow all of the PORC's assets to be held in the United States and the level of financial reporting is greatly reduced.

The PORC Transaction
The following is an example of a typical PORC transaction. The fact patterns may vary considerably from this example and may become quite complex. To properly understand a PORC transaction, it must be analyzed individually and the examiner must follow the flow of funds, understand the relationships between all parties, and analyze all documents.

A typical PORC transaction begins with a taxpayer that is engaged in the business of selling products and/or services to consumers e.g. a retailer, lender, auto dealership. Consumers may purchase products and services for cash or they may finance the purchase by executing an installment note, a revolving charge retail agreement with the taxpayer, or some other finance method.

As part of the transaction, the consumer is offered the opportunity to obtain an insurance contract in connection with the product or services being purchased. Customers are not required to purchase this insurance. However due to the high profitability of the products, they are aggressively promoted and many customers agree to purchase one or more of the insurance products.

The taxpayer may sell the insurance products to its customers as an agent for an unrelated insurance company or as the primary obligor on the product. The insurance may provide coverage for the property or the customer's ability to repay the outstanding loan balance in the event of unforeseen circumstances.

For example, acting as an agent, a retailer offers to sell an extended service contract to its customers as part of their sale of products. The contracts provide for the repair of any covered function of the product during the term of the contract. Typically, the contract provides the customer with coverage for repair or replacement costs if the item breaks down or is lost, stolen, or damaged. Alternatively, the retailer may offer a contract to the customer, which obligates the retailer to perform or pay to correct any product deficiencies. In either situation, the retailer may then arrange with an unrelated insurance company to provide insurance coverage for the risks associated with the insurance product sold by the retailer.

In a typical non-PORC structure, the producer receives an up-front sales commission equal to a percentage of the premium paid by the consumer for selling the insurance in accordance with an agency agreement. The producer may also share in the profitability of the insurance business by receiving a retrospective sales commission from the insurance company based on the loss experience of the insurance business. According to industry representatives, formation of a PORC provides the producer of insurance business another opportunity to share in the profits of this lucrative business. The off-shore domicile of a PORC facilitates the formation of this new profit center by allowing a reduced initial investment and minimal regulation.

Formation of the Off-Shore Entity

Generally, the producer or shareholders of the producer, with the assistance of a promoter, administrator, or other party, forms a PORC in a foreign jurisdiction with a nominal capital contribution. Caribbean islands such as Nevis and the Turks and Caicos islands are popular choices for PORC domiciles.

There are numerous factors that companies consider when deciding where to incorporate a PORC. For instance the company may look at the jurisdiction's requirement for:

- Capitalization
- Investment Restrictions
- Surplus
- Reporting
- Income and Local Taxes
- Government Fees
- Overall Regulatory Structure

Although formed in a foreign jurisdiction, funds in the PORC typically remain in the U.S and the investment of the funds is often directed by parties related to the producer. In addition, the PORC will usually make an IRC § 953(d) election to treat the PORC as a domestic insurance company. Depending upon the mix of business reinsured, the PORC may claim tax exempt status and file a form 990. Or it may claim favorable insurance treatment under IRC § 831(b) as a small property and casualty company or IRC § 806 as a small life insurance company.

The purpose of the PORC is to reinsure the risks of business initially placed with a "fronting" insurance company. The fronting company may be a well known traditional insurance company. Or it may be a company related to the promoter or administrator of the PORC transactions. Reinsurance is the transfer of risk and premium from one insurance company to another. In a typical transaction the fronting company transfers or "cedes" a percentage of the risk and the premium, less ceding fees, to the PORC.

The insurance policy and the reinsurance agreement create the impression that business is being conducted "offshore." Although the PORC may, in form, be off-shore, its business is generally carried on at the producer's business location, with funds typically deposited at the producer's U.S. bank or investment company.

Retailers typically agree to reduce their historic sales commission upon formation of the PORC. Additionally, any retrospective commissions which the retailer was entitled to receive prior to formation of the PORC are usually eliminated.

General Structure Example

Without a PORC

A U.S. retailer sells or leases electronics and furniture. The retailer sells a $100

insurance contract acting as an agent for a regulated U.S. insurance company. The retailer earns a $40 up-front sales commission and forwards $60 to the insurance company. The insurance company earns a $10 fee on the policy and provides a $50 retrospective commission to the retailer based on favorable loss experience. In this case, the retailer earned $90 on the sale of a $100 insurance policy.

With a PORC
A U.S. retailer sells or leases electronics and furniture. The retailer establishes a reinsurance company in the Turk & Caicos Islands, which makes an IRC § 953(d) election to be treated as a U.S taxpayer. The retailer sells a $100 insurance contract acting as an agent for a regulated U.S. insurance company, earns a $20 up-front sales commission, and forwards $80 to the insurance company. The insurance company earns a $10 ceding fee on the policy and forwards $70 to the reinsurance company as a reinsurance premium. In this case, the retailer has reduced its taxable income by $70 by transferring funds to the PORC.

POTENTIAL PORC AUDIT ISSUES

As discussed earlier, the potential legal positions on PORC issues are outlined in Notice 2002-70 as follows:

1) The PORC entity is not an insurance company
    - To qualify as an insurance company, the PORC must have as its primary and predominant business activity the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies.

2) The pricing of the insurance product must be arms length
    - If the pricing is not at arm's length, then the parties have failed to properly allocate income, deductions and other items between the taxpayer and its reinsurance company. Under this theory, additional income would be allocated to the taxpayer

3) The transaction may be a sham.
    - In appropriate cases, the IRS 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.

Applicable Code Sections

IRC § 953(d)
Although formed offshore to take advantage of limited capital requirements and lack of regulatory oversight, a PORC generally makes an election under IRC §953(d) to be treated as a U.S. corporation. Treatment as a U.S. corporation allows the PORC to utilize the favorable U.S. insurance tax provisions.

IRC § 953(d) allows a foreign corporation engaged in the insurance business to elect to be treated as a U.S. corporation for purposes of imposing U.S. tax. The election is available to a foreign corporation that is a controlled foreign corporation (as defined in IRC § 953(d)(1)(A)) that would be taxable under subchapter L for the taxable year if it were a domestic corporation. A corporation that makes the election under IRC § 953(d) must waive all benefits granted to it by the U.S. under any treaty between the U.S. and any foreign country.

To be effective for a taxable year, the IRC § 953(d) election must be filed by the due date prescribed in IRC § 6072(b), with extensions, for the U.S. income tax return that is due if the election becomes effective.

The election is effective for the first taxable year for which it is made and for each subsequent taxable year in which the requirements of Rev.Proc. 2003-47 and Notice 89-79 are satisfied.

The election can be made for taxable years beginning after December 31, 1987. If a foreign corporation makes this election, it will be subject to tax in the U.S. on its worldwide income.

IRC §4371

In general, section 4371 imposes an excise tax on each policy of insurance, indemnity bond, or annuity contract for hazards, risks, losses or liabilities, wholly or partly within the United States issued by any foreign insurer or reinsurer to or for, or in the name of a domestic corporation or partnership, or a resident individual. The tax imposed by this section is as follows:

1. 4% of the premium paid on a policy of casualty insurance or indemnity bond
2. 1% of the premium paid on a policy of life, sickness, etc
3. 1% of the premium paid on such reinsurance policies

Section §4371 Excise taxes do not apply when there is a valid 953(d) election. However, if the taxpayer is determined not to be an insurance company, the 953(d) election may be terminated.

Termination or revocation of the 953(d) election may cause the foreign reinsurer to be subject to the section 4371 Excise tax. In addition the revocation of a 953(d) election may cause the shareholders of the foreign corporation to be liable for Subpart F inclusions for taxable years in which the election is not effective.

Examiners should consult with an Excise Tax Specialist if it is determined that the PORC does not qualify as an insurance company, thus invalidating the 953(d) election.

IRC § 501(c)(15)

Prior to 1986, IRC § 501(c)(15) provided tax exemption for small non-life mutual

insurance companies. The Tax Reform Act of 1986 ("1986 Act") expanded the universe of IRC § 501(c)(15) organizations in two important respects: (1) It allowed stock companies to qualify for exemption as well as mutual insurers in an attempt to create parity between stock and mutual insurance companies and (2) It changed the measure of the dollar ceiling from a gross receipts test to a premium income test.

Because of these changes, there was a dramatic increase in the number of IRC 501(c)(15) applications for exemption from Federal income tax. After the 1986 Act, small for-profit insurance companies, insurance companies in liquidation, and reinsurance companies have applied for exemption under 501(c)(15).

The most advantageous tax treatment comes from the application of IRC § 501(c)(15) to the PORC. Under this provision, tax exemption is available to insurance companies, other than life insurers, if the net written premiums for the tax year do not exceed $350,000. Premiums from all members of the taxpayer's controlled group (as defined in IRC § 1563, with modifications) are aggregated for purposes of the $350,000 limitation. Two areas of abuse may occur from the use of a PORC operating under IRC § 501(c)(15).

IRC § 806

Another example of tax protection in an insurance company is that, while taxable, life insurance companies with assets less than $500 million get a special tax deduction under IRC § 806. This deduction is 60 percent of so much of their life insurance taxable income for the year as does not exceed $3 million. The deduction is phased out to the extent of 15 percent of their life insurance taxable income in excess of $3 million, and disappears entirely when the life insurance taxable income reaches $15 million.

IRC § 831(b)

A third example of tax protection involves insurance companies, other than life insurers, which have premiums in excess of $350,000 but no more than $1.2 million. Insurance companies, other than life, that meet this criteria can elect under IRC § 831(b) to pay tax on only their taxable investment income.

Conclusion

All PORC transactions may not be considered abusive. An examiner must gather and review all of the pertinent facts and circumstances surrounding the PORC transaction. Any challenges by the Service will very much fact-intensive and may vary case by case.

Currently, there are no "bright-line" tests to distinguish an acceptable PORC transaction from an unacceptable PORC transaction. Relying on existing guidance and depending upon the facts and circumstances of each case, an examiner will exercise auditor judgment to differentiate an abusive PORC transaction from a PORC transaction which complies with both the spirit and the letter of the law.