TAX INFORMATION RELATIVE TO

PRODUCER-OWNED OFFSHORE INSURANCE COMPANIES

TAX BIBLIOGRAPHY

Overview

This document has been prepared by Insurance Specialties and is intended to provide general and topical information in the tax area of Producer-Owned Reinsurance Companies, specifically those owned by automobile dealers. When an opinion is expressed, it is our opinion but every effort has been made to be as accurate and impartial as possible.

The Tax Bibliography document is divided into the following three sections:

1. A listing of the specific tax documents organized by type of document,
2. A listing of the specific reasons for including the document within this bibliography, and
3. The actual hyperlinked tax document.

Having given you a little guidance, please use this as you please. If you have any questions, comments, and/or criticisms, please e-mail them to carycope@wavelinx.net

TAX BIBLIOGRAPHY INDEX

BY DOCUMENT

<u>Internal Revenue Code</u>

- Section 806
- Section 831(b) (2)
- Section 501(c) (15)

Section 845
Section 953(d)
Notice 89-79
Notice 2004-64
Notice 2004-65
Subpart F

Court Cases

Carnation Company vs. Commissioner, 1978
Humana, Inc. vs. Commissioner, 1989 Kidde
& Co. vs. Commissioner
Hospital Corp of America vs. Commissioner
Sears/Allstate vs. Commissioner, 1991
Harper Group vs. Commissioner, 1992
Wright vs. Commissioner, 1993
Malone & Hyde vs. Commissioner, 1995
Rameau A. and Phyllis A. Johnson vs. Commissioner
United Parcel Service (UPS) vs. Commissioner, 1999
United Parcel Service (UPS) vs. Commissioner Appeals Court, 2001
First Security Bank of Utah vs. Commissioner
Trans City Life vs. Commissioner
Hinshaw vs. Commissioner

Revenue Procedures & Rulings

Rev Proc 92-97
Rev Proc 92-98
Rev Ruling 2001-31

Technical Advice Memorandums

TAM 9601001
TAM 9339001
TAM 9727014
TAM 9729002
TAM 9225003

Private Letter Rulings

PLR 9811055
PLR 1999-3024
PLR 1999-26033
PLR 200119039

Field Service Advices

FSA 1999-549
FSA 1999-553

FSA 1999-953
FSA 199915004
FSA 199945009

Other Documents
Additional Cost of SWIM
Shareholder Loans

Internal Revenue Code Summary

Section 806

Small Life Insurance Company Deduction - In addition to the general deductions listed in section 805, a life insurance company may be eligible for the small life insurance company deduction under section 806. To be eligible, a company must have gross assets of less than $500 million. The small life insurance company deduction for any tax year is 60 percent of the tentative life insurance company taxable income (LICTI) that does not exceed $3 million. The amount of the deduction is reduced by 15 percent of the tentative LICTI for the tax year that exceeds $3 million.

In general, "tentative LICTI" means life insurance company taxable income determined without regard to the small life insurance company deduction. The amount of the tentative LICTI for any tax year is determined without regard to all items attributable to noninsurance businesses.

Controlled Groups. For purposes of the small life insurance company deduction, all life insurance companies that are members of the same controlled group are treated as one life insurance company. Any small life insurance company deduction is allocated among the life insurance companies that are members of the group in proportion to their respective tentative LICTI's.

Section 831(b) (2)

Under section 831, insurance companies other than life insurance companies are generally taxed at the section 11 corporate rates (i.e. regular corporate tax rates).

Small Companies. If an insurance company's net written premiums (or, if greater, direct written premiums) for the tax year exceed $350,000 but don't exceed $1.2 million, the company can elect to be taxed only on taxable investment income. (Companies whose written premiums don't exceed $350,000 are potentially eligible for exemption from income tax under section 501(c)(15).)

The "Small Insurance Company" election applies to the tax year for which made and for all subsequent tax years. It can be revoked only with IRS consent.

Section 501(c) (15)

Section 501(c) of the IRC applies to tax-exempt entities and Section 501(c) (15) applies specifically to the qualification to become a tax-exempt casualty insurance company. The qualifications to become a tax-exempt entity are fairly rigid and the Service went through a period of time where they were not granting tax-exempt status to companies that applied for this exemption. In the past several years, the Service has again begun to start granting tax-exempt status (as we stated after adopting a policy of rejecting the applications for several years).

When determining if a casualty company qualified for tax-exempt status, not only is the annual premium volume (i.e. less than $350,000) taken into consideration, but also the (1) type of business and (2) ownership of the Insurance (Reinsurance) Company.

Section 845

Under section 845, when there's a reinsurance agreement between two or more related parties, the IRS can allocate among the parties and recharacterise income, deductions, assets, reserves, credits and any other items related to the reinsurance agreement in order to reflect the proper source and character of the items for each party. For this purpose, related parties are defined as they are in section 482.

In paragraph (b) of Section 845, the IRS can use its recharacterization authority for a reinsurance agreement between unrelated parties if the Service determines that the transaction has a "significant tax avoidance effect." This Code Section gives the Service fairly broad authority to recharacterise a reinsurance agreement if they deem there is a "significant tax avoidance effect," and this between either related or unrelated parties, but especially so for related parties.

Section 953(d)

This is the "Election by Foreign Insurance Company to be treated as Domestic Corporation." When accepted by the Service, this gives the taxpayer the right to file the tax return as a U.S. corporation and therefore be subject to all the regulations (and possible benefits) of being a U.S. corporation.

The instructions for filing are set forth in Notice 89-79 (below).

Notice 89-79

Section 953(d) Election Instructions - Notice 89-79 is the Service's guidelines and instructions for making the 953(d) election. Once the election is submitted, the Service reviews the election and then either approves or denies the election and returns the election to the taxpayer. When approved, a copy of the election is necessary to be attached to the income tax return that is filed.

Notice 2004-64

Notice 2004-64 describes the recent amendments to section 501(c) (15). PORCs typically are offshore entities that reinsure risks of customers of a related service provider, lender, or retailer. Many PORCs have taken the position that they are entitled to the special tax benefits available only to small insurance companies. Based on information that many of these arrangements were being used to shift income improperly to PORCs for purposes of avoiding income tax, the IRS and the Treasury Department identified PORC arrangements as listed transactions in Notice 2002-70.

Notice 2004-65

Notice 2004-65 removes certain reinsurance arrangements involving Producer-Owned Reinsurance Companies (PORCs) from the list of transactions identified by the Treasury Department and the IRS as "listed transactions" for purposes of the disclosure, list-maintenance, and registration requirements.

Section 952 Subpart F

This Section applies to Foreign Companies and Foreign Source Income of Domestic and Foreign Companies that have not made a 953(d) Election to be treated as a U.S. Corporation. It sets forth how various "foreign source" income and expenses should be treated for tax purposes.

Tax Court Cases

Following are tax court cases that have affected and continue to have an impact on the utilization of offshore insurance and reinsurance companies by U.S. entities.

Carnation Company vs. Commissioner, 1978

This was the original "self-insurance" court case wherein the tax court denied the deductibility of premiums paid by a parent company to its wholly owned subsidiary "captive" insurance company domiciled in Bermuda.

This case held precedence over the deductibility of premiums paid by parents to their captive insurance companies until 1991.

Humana, Inc. vs. Commissioner, 1989

This case was the first decision that allowed any deductibility of premiums paid to an "affiliated" insurance company. In this decision, the U.S. tax appeals court ruled that premiums paid by a "brother" insurance company to a related "sister" organization were deductible for tax purposes.

The court still held that premiums paid by a "parent" to its wholly owned "captive" insurance company were non-deductible, therefore this decision did not have wide spread applications, but it was the first taxpayer victory in this area.

It has been upheld by two subsequent court cases, Kidde & Co vs. Commissioner and Hospital Corp of America vs. Commissioner, therefore the creation of a brother/sister relationship is a very good means of establishing the deductibility of premiums paid to an affiliated insurance company. It should be remembered that this case can be used to establish deductibility in a brother/sister type of relationship, but is not applicable in a parent/subsidiary (i.e. parent/child) pure captive situation.

Kidde & Co vs. Commissioner

Favorable Decision that affirmed the deductibility of premiums paid to an affiliated insurance company with a brother/sister relationship.

Hospital Corp of America vs. Commissioner

Favorable Decision that again affirmed the deductibility of premiums paid to an affiliated insurance company in a brother/sister relationship.

Sears/Allstate vs. Commissioner, 1991

This case is one of the two criteria for establishing the "distribution of risk." This pertains to "related party premiums" insured (or reinsured) by an insurance company when there are also premiums paid by "unrelated parties." This was a landmark win for the taxpayer, Sears Roebuck and Company. In this case, Sears had paid premiums for its own insurance to its wholly owned subsidiary, Allstate (i.e. inside risk). The Service had historically denied the deduction for the insurance premiums paid to Allstate, even though Sears paid the same premium amount for the same coverage as all other Allstate customers. The Sears premiums represented less than one-half of one percent of Allstate’s total premiums, with the remaining premiums being paid by unrelated insured’s (i.e. outside risk). The tax court ruled that since there was such a high percentage of "outside risk" premiums, this created sufficient "distribution of risk" to make the "inside risk" premiums deductible.

Harper Group vs. Commissioner, 1992

This decision was an extension of the Sears/Allstate decision and helped to quantify the amount of "outside risk" necessary to make the "inside risk" deductible. Premiums paid by a parent company to its subsidiary are considered "inside risk," whereas premiums paid by a company to a non-related insurance entity are considered "outside risk." There were two important details to come out of this decision. The first was that the percentage of "outside risk" that was necessary to make the "inside risk" deductible was established at 30% (i.e. you need only 30% "outside risk" to make the other 70% "inside risk" deductible). The other important point is that the

Harper Group subsidiary was a foreign insurance subsidiary; therefore it legitimized the deductibility of premiums paid to a "foreign" insurance company.

There has recently been a proposal by the Clinton administration to codify the percentage of outside risk necessary to establish the deductibility of inside risk premiums at 50%. This has been proposed to Congress at least twice before and to date has not passed. This being an election year there is not thought to be much chance of it passing this year.

There has been a recent Field Service Advice (FSA) that the Internal Revenue Service was forced to release under the Freedom of Information Act that addresses the current position of the Service relative to "outside risk." The Service basically stated in FSA 1999-549 that this issue should be conceded (for the benefit of the taxpayer) unless there are other extenuating circumstances to develop an argument to deny the deductibility of premiums

Wright vs. Commissioner, 1993

This case represented the largest taxpayer loss to date in the producer-owned reinsurance community (i.e. the overall tax judgment, including taxes, interest and penalty was over $5.02.6 million dollars). The primary reason this case is mentioned is that anyone entering into an offshore Reinsurance Company program should know the potential pitfalls. The alternative reason is that this court case provides a very good outline of what not to do with Reinsurance Company. There were abuses and fraud committed (according to the judge) by both the Reinsurance Company owner and the Reinsurance Company manager that led to the ultimate decision. Fortunately for the reinsurance industry, there were so many flagrant abuses in this case that the Service has not been able to use this case effectively against other producer-owned reinsurance company programs.

The Reinsurance Company owner obviously abused the rules in running the Company, but it is worthwhile to mention three issues brought out in the testimony regarding the Captive Manager's conduct. The judge held that the Reinsurance Company was a "sham" company for tax purposes and disallowed the deductibility of premiums for all premiums paid by the affiliated company. Three factors going into her (i.e. the judge's) decision pertained to statements and documents relative to the Captive Manager, who, along with the Insurance Carrier "promoted the contemplated reinsurance transactions" according to court testimony. The statements and issues were:

1. **Tax Avoidance Program Literature** – A letter was introduced into evidence that was written by the Captive Manager that stated "*minimizing or deferring the tax event is the cornerstone of our operational plan*" (see Wright case summary, page 8).

   The statement in and of itself could have resulted in the verdict that was ultimately decided because the Service has the capacity to reverse any transaction if it is proven (or

determined) to have a significant tax avoidance effect (IRC Section 845(b)).

The lesson to be learned from this section of the trial is to always have a legitimate business reason for entering into a reinsurance transaction (and also not write any letters stating that taxes are the cornerstone of your operational plan).

2. **Regulatory Oversight** – In other testimony, a presentation by the Captive Manager was introduced into evidence. In his testimony, the Captive Manager testified that he had characterized the offshore Reinsurance Company as "*being outside the 'regulatory circle*'."

   The judge, in her ruling, stated that since the company operated "outside the regulatory circle," then it was not an insurance company. The subsequent ruling in the case was that the premiums paid by the dealership to the "Reinsurance Company" could not be deducted because it was not an insurance company; therefore they had to be reallocated back to the dealer.

   The lesson learned from this part of the trial is that your Reinsurance Company should be established in a legitimate, well-regulated domicile and should not operate "outside the regulatory circle."

   > Note: Since the trial the Turks & Caicos Islands (the country where the Wright's company was formed) have adopted comprehensive insurance legislation that should prevent a recurrence of the abuses in the Wright case. The Captive Manager involved in the Wright case has since moved their primary domicile to another island country (Nevis), which according to one international regulatory authority functionally has "no regulatory authority" that has regulations similar to those in affect in the Turks & Caicos Islands at the time of the Wright case.

3. **Over-Reserving** – The last item relative to the Captive Manager was the calculation of the credit insurance reserves. At that time (1991), an accepted reserve table was the 1958 Commissioner's Standard Ordinary (C.S.O.) Reserve Table. An allowable variation of this table is 130% of the 1958 C.S.O. However, instead of using this table (or the variation), the Captive Manager used a multiple factor of 160% of 130% of the 1958 C.S.O. Reserve Table. The result was that reserves were overstated by as much as 160%. This could possibly have been viewed as an oversight on the Captive Manager's part in and of itself, but it was also brought out in testimony that the Credit A&H reserves were also overstated. (See Wright case summary, page 11).

   Something that was never brought up in the trial was the specific reason "why" the credit insurance reserves were so high. When reviewing the court documents, it was brought to light that the Captive Manager's own insurance company was an intermediate reinsurance company and it was entitled to an "interest spread on the unearned premiums." What this meant is that the higher the reserves, the more income the Captive

Manager (through his intermediate Reinsurance Company) would have been entitled to. Therefore, one could speculate that the Captive Manager was the one actually benefiting by setting up the artificially high reserves, not the Reinsurance Company owner, who was the only person ultimately penalized.

In his summation, the judge repeatedly mentioned the overstatement of reserves as well as the other two factors brought into evidence. The subsequent fine against the taxpayer for (1) taxes, (2) penalty and (3) interest was over $5.02.6 million dollars (which far exceeded the overall income for this company).

The lesson to be learned from this section of the trial is to base the reserve calculations on industry recognized reserve tables (and maybe not let an intermediate company have access to your funds unless absolutely necessary).

The reason I mention this case in such length is that it was the most significant case up to that point in time, and the Internal Revenue Service made several statements to the effect that they were going to shut down the Industry because of it. This did not happen, primarily because there were such abuses (and fraud as stated by the judge, see Wright case summary, pages 33 & 34) practiced by both the Reinsurance Company owner and the Captive Manager that the Service realized they did not have good arguments to use against well-run reinsurance programs.

The industry has since gone to great lengths to differentiate legitimate programs from this type of program and prevent this sort of recurrence. This has included the formation of a task force by the Consumer Credit Insurance Association (CCIA) to specifically identify the potential pitfalls to avoid in structuring reinsurance programs.

In summary, the industry now has a good understanding of what should and should not be permissible in the operation of a Producer Owned Reinsurance Company program, and if the proper procedures are followed, there is substantial authority to establish the legitimacy of a properly run Reinsurance Company.

Malone & Hyde vs. Commissioner, 1995

In this court case, the tax appeals court ruled against the taxpayer and held that the premiums paid by the parent company to its wholly owned captive insurance company were nondeductible for tax purposes. The court gave three reasons for its decision:

1. *Indemnification* - The parent company had indemnified the non-related direct writer from any losses on the business reinsured into its wholly-owned subsidiary company.
2. *Parent/Child* - There was a parent/child relationship with no outside risk and the Carnation case still prevailed.
3. *Thinly capitalized* - The tax court held that the offshore company was thinly capitalized (i.e. the insurance company had $120,000 of Capital & Surplus).

This has become an important case in true parent/child captive situations, but has not been

effectively used in "brother/sister" situations. The industry as a whole is very aware of the need to eliminate any "indemnification" or "hold harmless" clauses in reinsurance agreements, especially when dealing with "offshore" captives.

The IRS has also issued several memorandums accepting the legitimacy of a "thinly-capitalized" offshore company (*TAM 9339001 for one*); in addition to a Supreme Court decision (*First Security Bank vs. Commissioner, 1972*) still in existence today that supports the legitimacy of a thinly capitalized company. In the case of First Security Bank, the captive subsidiary had $25,000 of Capital & Surplus.

Rameau A. and Phyllis A. Johnson vs. Commissioner, 1999

This was an unfavorable decision to the taxpayer and resulted in the denial of the deductibility of premiums held in an "escrow" account under a **retrospective type commission agreement**. In this judgment against the taxpayer, the tax court accepted the Service's position that since the dealer (Rameau Johnson) was entitled to the profits on the business, and since the funds were being held in an "escrow" account, then the premiums and investment income were includable on the taxpayer's return in the year of receipt.

It is my belief that if the premiums were held on an insurance company's books and treated as "insurance income," then there would not have been an adverse outcome.

United Parcel Service (UPS) vs. Commissioner, 1999

This is a recent tax court decision that went against the taxpayer. The significance is that this is the first case that has successfully been tried by the Service involving a true "tax-exempt offshore" insurance company. In this case, there were poor fact circumstances relative to the taxpayer, but they (UPS) have still appealed the decision and the offshore industry is eagerly awaiting the outcome of the appeal (note: the appeals court released their decision in 2001 and reversed the lower court decision in a significant victory for the taxpayer – see following). The poor fact situations as they pertain to UPS should assist the industry, as a whole, in defending against attacks by the Service using the UPS decision as a precedent (much as the poor facts in the Wright decision did regarding a Producer-Owned Reinsurance Company).

United Parcel Service (UPS vs. Commissioner, 2001 Appeals Court)

In a significant reversal of the decision against the taxpayer and probably more significant to private industry as a whole, the appeals court overturned the decision against UPS. In this decision, the appeals court upheld a taxpayer's rights to structure insurance (or reinsurance) programs that had tax benefits as long as there was also business purpose for the taxpayer. The decision did remand the case back to the lower court on two issues of taxpayer abuse.

First Security Bank of Utah vs. Commissioner, 1972

This case is important in the producer-owned reinsurance company industry because it affirmed the right of a parent (or affiliated) company to set up a Reinsurance Company for legitimate business reasons. The Reinsurance Company was a limited-capitalization, wholly owned Reinsurance Company of the insurance producer.

In this case, First Security was a bank that formed an insurance company to reinsure their own credit insurance. The reason for the formation of the company was because a bank was not allowed to receive commissions on credit insurance business in Utah under State Law. Federal banks were, however, allowed to form reinsurance companies under Federal Law. Therefore First Security formed an insurance company so that they could participate in the profits of the credit insurance sold to their customers. They capitalized the Reinsurance Company at $25,000, which was permissible in Arizona at that time.

The Supreme Court ruled that the bank (1) had the right to participate in the profits of their own business, (2) held that the Reinsurance Company was a legitimate business entity and finally (3) held that the credit insurance premiums sold on their own customers was "outside risk" because the premiums were being paid by the customer, with the bank acting only as an agent.

Trans City Life vs. Commissioner, 1996

This was a favorable tax court decision that involved an attempt by the Internal Revenue Service (Service) to reverse a reinsurance transaction under Section 845 of the Internal Revenue Code (IRC). This case was very important to the industry, because under Section 845, the Service has the power to reverse a reinsurance transaction if it can be determined the reinsurance transaction was entered into primarily for tax avoidance reasons. The business that was involved was Credit Insurance business. As stated, this was a favorable decision for the taxpayer (Trans City), but a fact that needs to be mentioned is that the Service issued an "Action on Decision" (AOD) subsequent to the verdict. An AOD is a notification by the Service that they disagree with the verdict and reserve the right to apply the same rules in subsequent cases involving similar issues. The burden of proof is, however, increased on the Service's part because of the previous verdict.

Hinshaw vs. Commissioner, 1994

The Hinshaw case involved a trust account established for an automobile dealer writing "Dealer Obligor" service contract business. Mr. Hinshaw had entered into a trust agreement with an insurance carrier that would enable him to participate in the profits of the business upon the expiry of the service contracts. The funds were held in a trust account, which was not recorded on the books of any insurance company. The tax court agreed with the Service's position that since the dealer was entitled to the profits upon the expiry of the business and the funds were held outside of any corporate structure, then the revenues had to be reflected on the dealership's books as they were received.

This decision has been upheld and has been successfully used in another type of "trust" arrangement (see Rameau A. and Phyllis Johnson vs. Commissioner).

Revenue Procedures & Rulings

Rev Proc 92-97

This Revenue Procedure was the initial document requiring an automobile dealer to amortize the cost of insurance over the life of a Vehicle Service Contract. The risk being insured was the dealership's payment to an insurance company to cover the Dealer Obligor risk on the vehicle service contract. The Service was able to take this position because they said that the vehicle service contract was an insurance policy for tax purposes, therefore a dealership had to deduct the cost of insuring the contract over the life of the contract. The result was the creation of significant amounts of taxable income to the dealership, because the dealership had received and recorded all the income from the customer, but they could only deduct a pro-rata share of the premium paid to the insurance company.

(See accompanying explanation and worksheet "Interest Lost on Dealer Obligor Vehicle Service Contract" for a development of the financial impact of this Rev Proc.)

Rev Proc 92-98

This Revenue Procedure was issued by the Service on the heels of Revenue Procedure 92-97. It was an effort by the Service to ameliorate the burden placed on the automobile dealers by Rev Proc 92-97. Instead of having to pay the total additional tax created by Rev Proc 92-97, the automobile dealer could elect to be taxed under the "Service Warranty Income Method" (or SWIM). The effect of this election was that the automobile dealer did not have to pay the full tax, but instead could pay a "fee" which was basically equivalent to the lost interest on the taxes if the taxes had been paid.

This is calculated on an annual basis, and creates not only additional tax, but substantial reporting requirements for the automobile dealer as well. It is only applicable to "Dealer Obligor" Vehicle Service Contracts.

Rev Ruling 2001-31

Revenue Ruling 2001-31 is one of the most important positive changes in position to date by the IRS relative to affiliated company insurance transactions. This ruling now allows the deductibility of premiums paid by a related company to another affiliated company (i.e. "economic family member"). This is a complete reversal of the historical position by the IRS relative to their position on disallowing the deductions of premiums paid from one member of an "economic family (i.e. companies with common ownership) to another member of the same "economic family." The primary reason for the change in position, as stated in their ruling, is the consistent findings of the tax court against the IRS when they (i.e. the IRS) have attempted to disallow the deduction in "properly structured" insurance transactions between affiliates. The Service, in releasing their Revenue Ruling, still reserved the right to look at affiliated

transactions based upon other circumstances, mentioning the Malone & Hyde vs. Commissioner decision (and consequently Wright vs. Commissioner).

The opportunity that this reversal in position presents is that a company can now insure (or reinsure) products that represent its own risk (such as Workmen's Compensation, Garage Liability and other traditional casualty products) through a properly structured program.

Technical Advice Memorandums

(For the definition of what is a "Technical Advice Memorandum," please see the "Private Letter Rulings" section below).

TAM 9601001

The request for this Technical Advice Memorandum (TAM) was brought about by the issuance of Rev Proc 92-97. The issue is if, the automobile dealer could not deduct the premiums paid for the purchase of an insurance policy to cover the Vehicle Service Contract, then a logical extension is that the Service would not allow an Administrator to immediately deduct a similar premium payment. This would potentially create substantial taxable income without corresponding funds, just like the impact to the automobile dealer in Rev Proc 92-97. The result would be the Administrator would have substantial tax liabilities without the corresponding funds to pay the taxes (because the premiums had been paid to an insurance company).

There was a favorable ruling issued by the Service to the taxpayer. The Service ruled that since the Administrator was basically issuing an insurance policy to the customer, then for tax purposes, this was Insurance Company. If it was an insurance company (for tax purposes), then the premiums paid by the Administrator to the insurance company ultimately insuring the service contracts, could be deducted as "reinsurance premiums" by the Administrator.

TAM 9339001

This TAM, issued in 1993, stated that the Service recognized the legitimacy of a limited capitalization offshore insurance company as an insurance company for tax purposes, which was a positive response relative to the acceptance of limited-capitalization offshore insurance companies.

This TAM also had a negative aspect. The Reinsurance Company insured Credit Life and A&H insurance under a Written/Earned type of reinsurance treaty (i.e. Life premiums were ceded on a "written basis and A&H premiums were ceded on an "earned basis"). Because of the method of ceding business, the Reinsurance Company qualified as a "Small Life Insurance Company" under IRC Section 806. The Service, using their ability to restructure reinsurance transactions that have a "significant tax-avoidance effect" under IRC Section 845(b), reallocated the A&H

reserves to the Reinsurance Company. The result was the Reinsurance Company went from being classified as a "life" insurance company to a "casualty" insurance company.

As a matter of course, this would not have had a material impact to the taxpayer, because instead of qualifying as a "Small Life Insurance Company," the taxpayer would have qualified as a "Small Casualty Insurance Company." However, because the "Small Casualty Insurance Company" election was not made contemporaneously with the filing of the original tax return, the Service did not allow the taxpayer to make this election retrospectively.

TAM 9727014

This TAM recognized "warranty supplements" sold on manufactured items as an insurance policy for tax purposes.

TAM 9729002

This TAM, released in 1997 disallowed the deductibility of "Dealer Obligor" Vehicle Service Contracts reinsured into a dealer-owned Reinsurance Company. This TAM potentially had some serious consequences to "Dealer Obligor" Service Contracts. The Service's position was that no transfer of risk took place because the dealer was both the premium payer (by the dealer-owned dealership) and the premium recipient (through the dealer-owned Reinsurance Company). The Service took the position that since both parties were related, then there was no transfer of risk outside the organization. The Service stated that "Risk Distribution" is required in order to be able to deduct the premiums.

The Industry's primary response to this interpretation has been to recommend that either a (1) brother/sister relationship is established (see FSA 1999-553) or (2) to create deductibility of "inside risk" premiums by insuring "outside risk" premiums (such as Credit Insurance or Administrator Obligor vehicle service contracts) (see FSA 1999-549, et al)

TAM 9225003

In this TAM the Service recognizes a "Vehicle Service Contract" issued by an insurance company to automobile dealers as an "insurance policy" for tax purposes.

Private Letter Rulings

First off, what is a Private Letter Ruling (PLR)?

PLR's are issued by the Internal Revenue Service's (Service) national office through the Office of Chief Counsel, which is part of the Legal Division, Department of the Treasury at the request of a taxpayer. The associate chief counsel issues most of these rulings. Under the Internal Revenue Code, PLR's are not precedent, and are considered binding on the Service only for the

taxpayers who request them. Despite the statutory prohibition, PLR's have, in a variety of settings, begun to emerge as legal authority. Increasingly, courts are citing those rulings along with Technical Advice Memorandum's (TAM's) in their opinions as persuasive authority.

PLR 9811055

This is one of the first of several Private Letter Rulings (PLR's) that the Service has issued which allows a non-insurance company that issues Vehicle Service Contracts (or other similar types of coverage) to be treated as an "insurance" company for tax purposes.

PLR 1999-03024

This PLR is one of several opinions by the Service stating that a company that issues vehicle service contracts can be treated as an insurance company for tax purposes.

PLR 1999-26033

This PLR also allows a non-insurance company to be treated as an insurance company. The specific product referenced in this PLR was a Roadside Assistance policy.

PLR 200119039

This recently published PLR is probably the most important in establishing a vehicle service contract as an insurance policy. The Service ruled that a Company that provides motor vehicle protection plans is an insurance company for tax purposes. It should be remembered that a PLR applies only to the company to which it was issued not to other taxpayers. This applies to reinsurance companies that reinsure both Administrator Obligor and Dealer Obligor service contracts.

Field Service Advices

A Field Service Advice is an internal document that is written by the National Office of the Internal Revenue Service (Service). This document is intended to provide Service personnel guidance in the specific area covered by the document. These were originally intended only for internal use, but in recent years the Service has been required to release these documents under the Freedom of Information Act.

FSA 1999-549

In this specific FSA, the National Office suggested that District Counsel should concede the deductibility issue if an insurance company has sufficient "outside risk" in a captive insurance company. The reason stated is because of the continuing acceptance by the tax courts of the deductibility of "related party" premiums paid by a parent to its captive subsidiary when "unrelated party risk" or "outside risk" is also present in the captive.

Types of insurance that would involve "unrelated party risk" would be either Credit Insurance or Administrator Obligor Vehicle Service Contracts because the premium payor (i.e. the customer or the AO Company) is unrelated to the payee (i.e. dealer-owned Reinsurance Company). Therefore, if a Reinsurance Company had "outside risk" or "unrelated party risk," this would help establish the deductibility or "inside risk" premiums (such as Dealer Obligor vehicle service contracts).

FSA 1999-553

This FSA mentioned the position of the courts in both "brother/sister" and "outside risk" circumstances and the fact that the courts have been consistent in favor of deductibility when these facts were present. Since the taxpayer involved in this case had both issues in its favor (i.e. "brother/sister" and "outside risk"), the recommendation by District Counsel was that the deductibility issue be conceded by the Service.

This FSA did not address the issue if only one of these facts was present, but it can be concluded that if both facts exist supporting the deductibility of premiums, the taxpayer position is better. Dealer Obligor (DO) vehicle service contracts are considered "inside risk" by the Service, therefore a product such as credit insurance would provide the "outside risk" to establish deductibility based upon "distribution of risk." There is still the "brother/sister" relationship that can establish the deductibility and there are other FSA’s that concede the deductibility when only one fact circumstance supporting deductibility exists.

FSA 1999-953

This FSA also pertained to the presence of "unrelated risk" and the recommendation of the District Counsel was to concede the issue of deductibility of premiums paid to an affiliated company by a taxpayer.

FSA 199945009

This FSA, rather than offering specific advice, instead requests that the facts in the case be developed further. But this is a very good document because it sets forth both the Service’s position and the industry’s (and fortunately most of the recent court’s position) on the deductibility of "related party" premiums paid to an affiliated insurance company. This FSA puts forth the argument for deductibility in both a "parent/child" and a "brother/sister" affiliated

structure.

It also puts forth the argument that the Service typically raises in regards to the non-deductibility of premiums paid to an "affiliated" insurance company, citing Revenue Ruling 77-316 and Revenue Ruling 88-72

Other Documents

Interest Lost on Dealer Obligor Vehicle Service Contract (Rev Proc 92-97 et al)

This worksheet is a calculation of the ultimate additional tax cost of a "Dealer Obligor" Vehicle Service Contract.

1. The first section of the worksheet illustrates the assumptions used in the worksheet.
2. The next section develops the "Yearly Lost Interest" due to the creation of income brought about by the deferral of the deduction and the corresponding tax payment. This section also develops the "annual interest lost" due to the tax payment.
3. The third section, "Future Value Calculation," calculates future value of the lost interest.
4. The last section, "Cumulative Cost of Amortization," demonstrates the year-by-year tax cost of each service contract.

Shareholder Loans

The IRS recently released a comprehensive Market Segment Specialization Program (MSSP) Audit Technique Guide on Shareholder Loans. This Audit Guide (which can be found at http://ftp.fedworld.gov/pub/irs-mssp/a8shloan.pdf) provides valuable information for tax professionals setting up, monitoring, or reporting the tax consequences of shareholder loans from corporations. It pinpoints the problem areas that IRS agents are instructed to probe for, and explains how imputed interest should be calculated in a variety of term-and demand-loan situations, complete with spreadsheet formulas.