



# CLIENT ALERT

## IRS WILL ATTACK CERTAIN PRODUCER-OWNED REINSURANCE COMPANIES (PORCs)

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Notice 2002-70, issued on October 15, 2002, warns taxpayers that the Internal Revenue Service (the "IRS") will disallow federal income tax benefits from transactions involving producer-owned reinsurance companies ("PORCs") that the IRS believes are abusive. The IRS believes that certain PORC structures are used by taxpayers to shift income from taxpayers to their related companies purported to be insurance companies that are subject to little or no U.S. federal income tax. Taxpayers, their representatives, and promoters of the transactions described in the Notice may be subject to certain reporting and record-keeping obligations and penalties.

While some PORCs may fall within the scope of the Notice, we believe there are many legitimate PORCs that should not be affected by the Notice.

### EFFECTIVE DATE AND "TAX SHELTER" FILING REQUIREMENTS

Transactions that are the same as, or substantially similar to, the PORC transaction described in the Notice are identified as "listed transactions" for purposes of tax shelter disclosure, registration and list maintenance requirements.

Taxpayers who participate in PORCs described in the Notice after October 15, 2002, must attach a disclosure statement to their federal income tax return for each taxable year for which the taxpayers' tax liability is affected by their participation in a PORC transaction. At the same time, a copy of the disclosure statement must be filed with the Office of Tax Shelter Analysis. Taxpayers with existing PORCs that are covered by the Notice will be required to disclose their participation in these PORC transactions at the time these taxpayers file their next federal income tax returns after the issuance of the Notice.

Promoters of PORCs covered by the Notice must register their PORC structures with the IRS not later than the day on which the first offering for sale of such PORC occurs after October 15, 2002. In addition, promoters are required to maintain lists identifying persons who acquire interests in PORCs covered by the Notice.

### TYPICAL TRANSACTION

In a typical transaction, as described in the Notice, a service

provider, automobile dealer, lender, or retailer ("Taxpayer") sells its customers insurance, extended warranty coverage or other similar insurance type coverages in connection with the products or services sold by Taxpayer. The insurance contract is issued by an unrelated insurance company ("Company X") and 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. Acting as an insurance agent for Company X, Taxpayer receives a sales commission from Company X equal to a percentage of the premiums paid by Taxpayer's customers.

Taxpayer typically forms a foreign wholly owned corporation ("Company Y") that enters into a reinsurance agreement with Company X to reinsure all insurance policies sold by Taxpayer to its customers. If Company Y is a foreign corporation, it elects to be treated as a domestic insurance company under section 953(d) of the Internal Revenue Code. Company Y takes the position that it is entitled to one of the following tax benefits:

- 1) The company is a tax-exempt non-life insurance company whose premiums written for the taxable year do not exceed \$350,000;
- 2) The company is entitled to a special deduction as a "small" life insurance company having life insurance company taxable income not in excess of \$15,000,000; or
- 3) The company is a qualifying non-life insurance company with net written premiums between \$350,000 and \$1,200,000 that elects to be taxed solely on investment income.

Taxpayer remits premiums received from its customers to Company X (net of Taxpayer's sales commission). Company X pays any claims and state premium taxes due and retains a portion of the premiums received from Taxpayer. Under the reinsurance agreement with Company Y, Company X transfers the remainder of the premiums to Company Y as reinsurance premiums.

### GROUND S FOR IRS CHALLENGE

The Notice explains that the IRS is concerned that reinsurance

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arrangements similar to the one described above have been wrongfully used by taxpayers to divert income properly attributable to Taxpayer to Company Y, which is subject to little or no federal income tax. The IRS intends to challenge these transactions on the following grounds:

- The IRS may assert that Company Y is not an insurance company for tax purposes and thus does not qualify for the benefits of Code provisions that would allow Company Y to be subject to little or no federal income tax. Company Y would not qualify as an insurance company for tax purposes if the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies is not the primary business activity of Company Y. In determining whether Company Y qualifies as an insurance company, the IRS will consider all the relevant facts, 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.
- The IRS may reallocate income from Company Y to Taxpayer under Code sections 482 or 845 to clearly reflect the income of Taxpayer and Company Y. Under these provisions, the IRS may test direct or indirect transactions between persons directly or indirectly owned or controlled by the same interests to determine that the terms are at arm's length.
- The IRS may disregard the insurance and reinsurance arrangements if the arrangements are shams in fact or shams in substance. The courts have distinguished between "shams in fact" where the reported transactions never occurred and "shams in substance" where the transactions actually occurred but lacked business purpose and economic substance, apart from tax consequences. As a result, Taxpayer would be required to recognize an additional portion of premiums received from its customers as its own income.

## CONSEQUENCES FOR TAXPAYERS WITH PORCS

Taxpayers who own interests in PORCs should review their structures to determine whether those PORCs are distinguishable from the transaction described in the Notice. Unfortunately, the IRS does not provide any clear guidelines on what transactions will be treated as substantially similar to the "typical transaction." We suspect that the omission of guidelines by the IRS is not accidental.

It appears that the Notice should not apply to PORCs that do not utilize one of the three enumerated federal income tax benefits. In addition, it is not clear whether the Notice is intended to cover service contract arrangements where the taxpayer (a service provider, auto dealer, etc.) is the party liable under service contracts with its customers. Finally, many taxpayers may determine that their reinsurance arrangements are sufficiently different from the transaction described in the Notice.

Despite the uncertainty regarding PORCs that is created by the Notice, it is clear that tax shelter reporting requirements will apply to PORCs that are the same or substantially similar to the structure described in the notice, irrespective of the fact that the PORC is not a sham, qualifies as an insurance or reinsurance company for federal income tax purposes and the PORC transaction directly and indirectly utilizes an arm's length standard. The fact that a transaction utilizes one of the three enumerated tax benefits should not, per se, cause an arrangement not to be recognized as a valid transaction for federal income tax purposes or to come within the tax shelter reporting requirements. Every insurance and reinsurance transaction, including PORC structures, must be a legitimate transaction as opposed to a sham, constitute insurance for tax purposes and be priced at arm's length in order for its intended tax treatment to be upheld. These requirements were in place long before the IRS issued the Notice and should continue to be satisfied by all properly structured PORCs.

We suggest that insurance companies and brokers who issued or sold PORCs advise their customers (service providers, auto dealers, etc.) to consult a tax advisor to determine whether their existing PORC arrangements would be affected by the Notice.

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