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IRS Retreats From Attack On Producer-Owned Reinsurance Companies (PORCs) And Gives Guidance On New Requirements For Tax-Exempt Insurance Companies

The Internal Revenue Service on September 25, 2004 issued two notices affecting small insurance companies. In Notice 2004-65 the IRS advised that reinsurance arrangements involving producer-owned reinsurance companies ("PORCs") and similar insurance arrangements will no longer be considered "listed transactions" for purposes of the tax shelter disclosure, list maintenance and registration requirements. In the nearly two years since the IRS issued Notice 2002-70 which designated PORCs as listed transactions (see our Client Alert, "[IRS Will Attack Certain Producer-Owned Reinsurance Companies \(PORCs\)](#)," October 2002) examinations by the IRS "revealed fewer abusive transactions than anticipated." In addition, the amendments that the Pension Funding Equity Act of 2004 ("PFEA") recently made to Code section 501(c)(15), which provides tax-exempt status for certain small property and casualty insurance companies, are expected to preclude most PORCs, as well as most other parent-subsidiary and brother-sister captive insurance arrangements, from qualifying for tax-exemption. Guidance on these amendments was provided by the IRS in companion Notice 2004-64.

NOTICE 2004-65

Notice 2002-70 required that taxpayers who participate in PORCs described in the Notice must attach a disclosure statement to their federal income tax returns and file a copy of the disclosure statement with the Office of Tax Shelter Analysis. The factual pattern described in Notice 2002-70, which listed PORCs as potentially abusive transactions, involved a taxpayer the IRS stated was "typically a service provider, automobile dealer, lender, or retailer" (the Producer) who offers insurance, such as credit or extended warranty coverage, in connection with the products or services sold by the Producer. In offering the insurance, the Producer acted as an agent for an unrelated insurance company that provided the insurance coverage, which was then ceded to a reinsurance company owned by the Producer. The reinsurance company was typically located offshore, but elected under Code section 953(d) to be treated as a domestic insurance company for Federal tax purposes and claimed the tax benefit

of Code section 501(c)(15) or similar provisions.¹ The IRS stated in Notice 2002-70 that the purpose of "many" of the transactions that are the same or similar to the one described in Notice 2002-70 is to divert income properly attributable to the Producer to a related company that was subject to little or no U.S. tax. The IRS further announced that it would attack PORCs on any of several grounds: (1) the PORC is not an insurance company for tax purposes because its primary and predominant business is not insurance or reinsurance, (2) income should be reallocated from the PORC back to the Producer or otherwise recharacterized to reflect the proper source and character of the income (i.e., "transfer pricing" adjustments under Code section 482 or 845), and (3) the arrangements are shams that should be disregarded for tax purposes.

Although the IRS in Notice 2004-65 has backed down from its position that PORC transactions, and those substantially similar to them, should be "listed transactions," the Notice cautions that PORC transactions may otherwise still be subject to tax shelter disclosure, registration or list maintenance requirements. It further cautions that the IRS will continue to scrutinize such transactions to determine if they are being used to shift income to related persons subject to little or no U.S. federal income tax. Although Notice 2004-65 specifically lists only transfer pricing, and not the two other grounds for attack listed in Notice 2002-70, there is no reason to believe that the IRS will not apply any of a variety of grounds in evaluating whether an arrangement will be respected as insurance for federal income tax purposes. Indeed, the Senate Finance Committee Report states that Congress intends for the IRS to issue anti-abuse regulations or other guidance to prevent improper use of the exemption.

NOTICE 2004-64

Prior to the recent amendments made to Code Section 501(c)(15) by PFEA, a non-life insurance company was generally exempt from federal income tax if its written premiums for the taxable year (along with the written premiums of other members of its controlled group) did not exceed \$350,000. Many PORCs and small brother-sister or parent-subsidiary captive insurance

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companies, as well as other small or start-up insurance companies, claimed tax-exemption under this provision.

The amendments made by PFEA were enacted on April 10, 2004 and are effective for taxable years beginning after December 31, 2003.² The amendments no longer refer to written premiums; instead, a stock non-life insurance company will be exempt if (1) its gross receipts for the taxable year do not exceed \$600,000, and (2) more than 50 percent of such gross receipts consist of premiums. Mutual companies are subject to alternative rules limiting gross receipts to \$150,000, more than 35 percent of which must consist of premiums.³ All members of the insurance company's controlled group, including non-insurance companies, are taken into account for the purpose of determining gross receipts and premiums. Accordingly, the gross receipts of a Producer from all of its activities, including its retail, lending, or other businesses, are likely to preclude most if not all PORCs from qualifying for tax-exempt status. Similarly, parent-subsidiary and brother-sister captives will typically fail to qualify for tax-exempt status.

Notice 2004-64 provides two examples of the change in law which focus on the mathematics of the change. In the first example, a non-life insurance company having premium income of \$350,000 or less, but \$650,000 of gross receipts, would have been exempt under prior law, but as its gross receipts are in excess of \$600,000, it is not exempt under the amendment. In the second example, an insurance company with \$500,000 of gross receipts, including \$375,000 from premiums, would qualify for tax exemption under the new law, but would have failed to qualify under the old law. Finally, the example notes that if that company were a member of a controlled group, it would not qualify under the amendment if other members of the group have gross receipts in the taxable year in excess of \$100,000, causing the group to fail the \$600,000 gross receipts test. It is for this reason that most PORCs and parent-subsidiary and brother-sister captives will fail to qualify for tax-exempt status.

Notice 2004-64 concludes with warnings to taxpayers that it will continue to challenge the exemption of any entity that claims to be described in Code section 501(c)(15), regardless of whether the entity received a determination letter. Presumably, the grounds for the challenge, assuming the numerical test or tests are at least facially met, are the same as for PORCs generally, viz., that the entity should not be treated as an insurance company, that the entity is a sham, or that the

income of the entity should be recharacterized or reallocated, causing it, for example, to fail to be engaged primarily and predominantly in the insurance business.

CONCLUSION

The removal of PORCs (and the ambiguous "substantially similar" transactions) from the tax shelter reporting requirements is certainly a welcome retrenchment by the IRS. Of course, the amendment of section 501(c)(15) will reduce the ability of a broad range of insurance arrangements, including PORCs, to qualify for tax-exemption, and thus reduce the tax benefits potentially available for engaging in such arrangements. Nevertheless, many potential tax benefits remain for PORCs, captives and all other insurance companies. However, they must satisfy all applicable tax standards to maintain their status as insurance companies and to have their transactions respected as insurance for federal income tax purposes. Our Client Alert, "Recent IRS Captive Insurance Company Rulings," January 2003, discusses many of these tax standards.

Endnotes

- 1 Other provisions would include Code section 806, which allows certain life insurance companies to deduct 60 percent of their life insurance taxable income (before taking into account the deduction) if the company's life insurance taxable income does not exceed \$15 million, and Code section 831(b), which allows certain non-life insurance companies with net written premiums between \$350,000 and \$1.2 million to elect to be taxed only on investment income.
- 2 PFEA added a definition for non-life insurance companies which, like life insurance companies, requires that more than half of their business consist of the business of insurance or reinsurance.
- 3 PFEA also made a change affecting the taxation of life insurance companies. Applicable to tax years beginning after December 31, 2004, Code section 809 was repealed. This section reduced the deduction that could be claimed by mutual life insurance companies for dividends paid to policyholders and certain reserves.

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