OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

March 31, 2000

Number: **200027008**
Release Date: 7/7/2000
CC:INTL:Br5/WTA-N-109504-99
UILC: 845.00-00
482.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR CHIEF, VIRGINIA-WEST VIRGINIA APPEALS OFFICE
Att.

FROM: Jeffrey L. Dorfman, Chief, CC:INTL:Br5

SUBJECT:

This Field Service Advice responds to your memorandum dated January 4, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Appeals Officer =
Products =
Taxpayer =
SUB =
Insurer A =
Insurer B =
Country A =
Date Q
$AA =
$BB =
$CC =
$DD =
$EE =
$FF =
$GG =
$HH =
$II =
$JJ =
$KK =

ISSUES

1. Whether premium income received by the Taxpayer's wholly-owned insurance subsidiary from an unrelated insurance company pursuant to a reinsurance agreement should be allocated to the Taxpayer for one or more of the following reasons: (a) the subsidiary is a sham corporation; (b) the reinsurance agreement does not constitute valid reinsurance; and/or (c) the reinsurance transaction otherwise lacks economic substance?

2. Alternatively, assuming the reinsurance transaction is respected, whether the Service may allocate premium income received by the insurance subsidiary to the Taxpayer under sections 482 or 845.

CONCLUSIONS

1. The facts need to be more fully developed. Based on the information we have received to date and the representations made by the Appeals Office, the facts suggest that: (1) the insurance subsidiary should not be treated as a sham corporation; (2) the reinsurance agreement should be respected as valid reinsurance; and (3) the reinsurance transaction did not lack economic substance. However, the facts, once fully developed, may support the conclusion that the transaction lacked economic substance. Under these circumstances, all premium income received by the reinsurance company would be allocated to the Taxpayer and the reinsurance transaction treated as a sham.

2. Sections 482 and 845 can be used to allocate a portion of the premium income received by the insurance subsidiary to the Taxpayer because a portion of the premium income is really a disguised sales commission earned by the Taxpayer.

FACTS

The Taxpayer is engaged in the business of selling products to consumers and often sells products to consumers on credit. As part of a credit sale, the Taxpayer offers, as an agent for an unrelated insurance company ("Insurer A"), to sell credit insurance to its customers including credit life, property, and unemployment insurance. Customers designate the Taxpayer as the beneficiary of the insurance policies and the insurance policies provide coverage during the period that a loan is outstanding. The insurance proceeds are used to repay any outstanding loan balance in the event the customer dies or becomes unemployed or the property is destroyed or stolen.

The Taxpayer receives commissions for selling insurance. Before the years in issue, the Taxpayer generally received (1) a 50% sales commission on single premium credit life insurance, (2) a 60% on single premium credit property insurance, and (3) a 25% commission on single premium unemployment insurance. The Taxpayer also received a retrospective sales commission ("retro refund") from Insurer A based on the loss experience of the insurance business as a whole, rather than on a policy-by-policy basis. The Taxpayer received a retro refund equal to the amount, if any, by which the premiums paid by customers (net of the up-front sales commission) exceeded the insurer's expenses and loss experience.

On Date Q, the Taxpayer formed an insurance company ("SUB") in Country A with a capital contribution of $KK. SUB had no employees and paid no compensation to any of its officers. All of SUB's officers were also officers of the Taxpayer. SUB is not regulated by any State or agency of the United States and uses the Taxpayer's address as its mailing address. SUB's only insurance activities relate to the reinsurance of insurance sold by the Taxpayer to its customers.

SUB erroneously filed its income tax return on a fiscal year basis, and has agreed to make the necessary adjustments to conform its income tax return to a calendar year income tax return. Additionally, SUB and the Taxpayer filed their income tax returns as if SUB had made a valid section 953(d) election to be treated as a domestic insurance company. Although the election was not done properly, SUB recently received section 9100 relief regarding the election.

The Taxpayer formed SUB to reinsure risks that were directly insured by Insurer A. Under a reinsurance treaty, Insurer A ceded all of the Taxpayer's credit insurance to SUB. The reinsurance treaty provided that the credit life insurance was reinsured on an "as written" or "as issued" basis. Thus, Insurer A transferred reserves (assets) for the credit life insurance to SUB. However, the credit property and credit unemployment insurance was reinsured on an "as earned basis." Thus, Insurer A retained the reserves for property and unemployment insurance until it was earned.

SUB was required to place the reserves supporting its reinsurance business in a trust. The trust could only release reserves if authorized by both Insurer A and SUB. The reserves remained in trust until after the policies expired. Insurer A had a security interest in the trust.

Upon formation of SUB, the Taxpayer agreed to reduce its sales commission from 50% to 40% of the net premium for credit life insurance and from 60% to 40% of net premium for credit property insurance. The Taxpayer continued to receive a 25% commission of the net premium for unemployment insurance sold to customers. The Taxpayer states that Insurer A required the commission rates to be reduced due to the higher risk associated with SUB's low level of capitalization. The Taxpayer was no longer entitled to receive retro refunds. As a result of the Reinsurance transaction, the retro refunds were effectively transferred to SUB.

The following examples illustrate the insurance transactions before and after the formation of SUB.

Before SUB was formed, the Taxpayer would receive a $100 premium for a credit life insurance policy. The Taxpayer would keep $50 (50% of $100 as a sales commission on credit life policies), and forward the remaining $50 ($100 premium minus the $50 sales commission) to Insurer A. From the remaining $50, Insurer A would deduct an administrative fee equal to 10% of the premium amount (or $10), and earn investment income for 2 years on the remaining $40. Assuming no losses were claimed on the policy, the $40 would be paid out to Taxpayer as a retro refund. Thus, if Insurer A earned a 10% rate of return on the funds representing the future retro refund, Insurer A would earn $18 from the insurance transaction {[$10 (administrative fee)] + [($40 x 10%) x 2 (years)]} over a two-year period. The Taxpayer would earn $90 ($50 sales commission plus $40 retro refund). If Insurer A paid $15 for claims under the policy, then the retro refund would be reduced to $25 ($40 - $15), leaving Taxpayer with $75 from the insurance policy.

After SUB was formed, assuming there were no claims under the policy, the Taxpayer would receive only $40 (40% sales commission), rather than $90, from the above transaction. The remaining $60 would go to Insurer A. Insurer A would retain $10 as an administrative fee and transfer $50 to SUB as a reinsurance premium. No retro refunds were to be paid by either SUB or Insurer A to the Taxpayer.

Insurer A maintained SUB's insurance books, supervised and paid all claims arising under the insurance policies, and calculated SUB's reserve liabilities in accordance with National Association Insurance Commissioners ("NAIC") standards. At various times during Insurer A's relationship with the Taxpayer, losses on <u>credit life</u> insurance policies exceeded the premiums received on the <u>credit life</u> insurance polices. However, we have no information concerning whether losses on <u>all</u> risks ceded to SUB exceeded premiums. Rather, we only have general information that, overall, the insurance sold by the Taxpayer was very profitable because claims tended to be small and relatively infrequent. Due to the high profits associated with the business, it is our understanding that the Taxpayer enjoyed a substantial amount of bargaining power in selecting the direct insurer.

After the Reinsurance transaction occurred, the Taxpayer terminated (prospectively) its relationship with Insurer A in favor of another direct writer of insurance, Insurer B. Insurer B offered higher commissions to Taxpayer -- 50% on all business it produced, rather than the 40% and 25% rates paid by Insurer A. For purposes of our analysis, we will only refer to Insurer A as the direct insurer, as we do not believe the change in direct insurer from Insurer A to Insurer B has a meaningful effect on the outcome of our analysis. Additionally, it is our understanding that during the tax years before us, most of the transactions at issue involved Insurer A as the direct insurer.

The following chart represents select tax figures of SUB:

Tax item	**FYE 1995 ($)**	**FYE 1996 ($)**
Life insurance gross income	HH	II
Taxable income	BB	EE
Small life insurance co. deduction	DD	GG
Dividends to taxpayer	CC	JJ
Loans to taxpayer (principal amount)	AA	FF

LAW AND ANALYSIS

A. Introduction

The facts of this case are similar to the those addressed by the Tax Court in *United Parcel Service of America, Inc. v. Commissioner*, T.C. Memo 1999-268 (“UPS”) and *Wright v. Commissioner*, T.C. Memo 1993-328 affd. 76 A.F.T.R. 2d (RIA) 8096 (9th Cir.1995). In both cases, the taxpayers established thinly capitalized foreign insurance companies with no employees. The reinsurance companies reinsured risks arising solely from the sale of insurance to customers of the taxpayers through unrelated insurance companies. The reinsurance transactions shifted income from the taxpayers to the reinsurance companies. In each case, the Tax Court held that the reinsurance transaction effected an impermissible assignment of income and lacked economic substance. Thus, reinsurance premiums were reallocated from the reinsurance company back to the taxpayer.

In *the UPS* case, the Tax Court concluded that an impermissible assignment of income occurred after considering: (1) the functions performed by the taxpayer before and after the reinsurance transaction; (2) the risks assumed, if any, by the direct insurer in the transaction and whether it merely received a fee for performing a pre-designed role; and (3) the economic substance and business purposes underlying the entire transaction.

The facts of the present case and the *UPS* and *Wright* cases are similar. However, the present case appears to be factually different than the *UPS* and *Wright* cases in some important respects. Specifically, SUB elected to be taxed as a U.S. corporation under section 953(d). SUB appears to be adequately capitalized and to have reinsured significant risk. After the reinsurance transaction, the Taxpayer still received a substantial up-front sales commission. The Taxpayer claims that the reserves held by SUB were calculated by an actuary applying NAIC standards and that those reserves are sufficient to support the reinsurance transaction. The premiums received from Insurer A were set aside in a trust and the Taxpayer claims that this allowed Insurer A to claim surplus credit for the reinsurance. No evidence suggests that the Taxpayer represented to third parties that it was the insurer rather than Insurer A.

We emphasize that the facts are not completely developed. Nevertheless, based on the available facts, we believe that SUB is not a sham corporation and that the reinsurance transaction should be respected as valid reinsurance. This conclusion may change, however, when the facts are more fully developed. It appears that the business purpose for the reinsurance transaction was to enable the Taxpayer to capture the investment income that Insurer A was earning on the insurance reserves. For this to be a sufficient business purpose, the amount of investment income captured should be substantial in comparison with any tax benefits derived from the transaction. Relevant to this analysis is whether alternative means of capturing the investment income were available that would not have had such a tax avoidance effect. See *UPS v. Commissioner*, *supra*.

The facts also strongly suggest that the reinsurance transaction was used to improperly assign sales commission income earned by the Taxpayer to SUB. In computing its taxable income, SUB reduced its taxable income substantially by claiming the small life insurance company deduction under section 806 and the life insurance reserve deduction under section 807. Thus, the tax imposed on income on earned by SUB would be less than the tax imposed on the same income earned by the Taxpayer. The Taxpayer cannot assign sales commission income to another related taxpayer. Discussed below are the reasons why a portion of the premium income received by SUB should be reallocated to the Taxpayer under sections 482 and 845.

B. <u>Section 482</u>

Section 482 can be considered to be an amalgam of economic substance, assignment of income, and clear reflection of income principles. *See Stewart v. Commissioner*, 714 F.2d 977, 987 (9th Cir. 1983), *citing*, B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 15.06, at 15-16 (4th Ed. 1982). Section 482, in part, provides:

> In any case of two or more organizations, trades, or businesses (whether incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or in directly by the same interests, the Secretary may distribute, apportion, or

> allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any organizations, trades, or businesses.

In *Local Finance Corp. v. Commissioner*, 48 T.C. 773 (1967), *aff'd*, 407 F.2d 629 (7th Cir. 1969), *cert. denied*, 396 U.S. 956 (1969), *overruled in part on other grounds*, *Commissioner v. First Sec. Bank*, 405 U.S. 394 (1972), the Tax Court sustained the Commissioner's use of section 482 to reallocate income from an insurance company to its corporate parent in a case with facts essentially identical to the present case. The relevant facts of the *Local Finance Corp.* case can be summarized as follows.

As part of their financing business, a group of commonly controlled financing companies (the "finance companies") sold credit life insurance to borrowers. The credit insurance was underwritten by an unrelated insurance company. The unrelated insurance company indirectly paid sales commissions to the finance companies for selling the insurance by paying a commission to an officer of the finance companies.[1] The officer in turn assigned the commissions to a corporation controlled by the same shareholders that owned the finance companies.

The finance companies received a sales commission equal to 40 percent of the premiums received. In addition, the finance companies received a contingent sales commission in an amount equal to the premiums (net of the up-front sales commission) reduced by an administrative fee and any claims paid on the policies. Id. at 786.

The finance companies subsequently formed an insurance company ("reinsurance company") to reinsurance the risks insured by the unrelated insurance company. The unrelated insurance company entered into a reinsurance agreement with the reinsurance company to reinsure the risks of the finance companies' customers for 90.5 percent of the net premium. The unrelated insurance company retained 9.5 percent of the net premium and no longer paid any commissions, fixed or contingent, to the finance companies. *Id.* at 786-7.

The Service allocated a portion of the reinsurance premiums (50 percent of net premium) received by the reinsurance insurance company to the finance companies

---

[1]In the *Local Finance Corp.* case, the finance companies could not receive a commission for selling credit insurance under state law. *Local Finance Corp. supra* at 777.

under section 482. The Tax Court upheld the allocation of income to the finance companies because it was clear that a portion of the premium was really a sales commission earned by the finance companies for selling and servicing the insurance. After establishing a reserve to pay claims, the reinsurance company was left with approximately 8.4 percent of the net premium. *Id.* at 790-1.

Based on the facts we have been provided, it appears that the Taxpayer has assigned a portion of both its up-front sales commission and its retrospective sales commission to SUB through the reinsurance agreement. Before the reinsurance transaction, the Taxpayer was entitled to an up-front sales commission equal to a specified percentage of the premium and a retrospective sales commission based on the claims experience of the insurance policies. After the reinsurance transaction, the Taxpayer's up-front sale commission percentage was reduced and the retrospective sales commission was eliminated. It is very unlikely that the Taxpayer would have entered into an arm's length agreement with an unrelated party on these terms. The amount by which the reinsurance premium paid to SUB exceeds the amount that would have been paid to an unrelated party for similar reinsurance is almost certainly a sales commission earned by the Taxpayer that is being diverted to SUB. Thus, the Service may reallocate a portion of the premium income received by SUB to the Taxpayer under section 482.

We note that in *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972), the Supreme Court held that section 482 did not authorize the Commissioner to allocate income to an organization when that organization was legally prohibited from receiving that income. In the present case, the record does not show that any law prevents the Taxpayer from receiving sales commissions. In fact, the Taxpayer received sales commissions directly from Insurer A (both up-front commissions and retro refunds) before SUB was formed. Thus, the Service may allocate income received by SUB to the Taxpayer under section 482.

C. <u>Section 845</u>

In addition to section 482, the Internal Revenue Code contains two additional reallocation provisions that apply specifically to insurance companies. Section 845(a) generally allows the Secretary to reallocate income between two or more related parties who are parties to a reinsurance agreement. Section 845(b) generally allows the Secretary to reallocate income between unrelated parties who are parties to a reinsurance agreement if the reinsurance contract has significant tax avoidance effect. For the reasons discussed below, section 845(a) may also be used to reallocate premium income received by SUB from Insurer A back to the Taxpayer.

1. <u>Section 845(a)</u>

Section 845(a) provides:

> In the case of 2 or more related persons (within the meaning of section 482), who are parties to a reinsurance agreement (or when one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to such agreement or a conduit between related persons), the Secretary may-
>
> (1) allocate between or among such persons income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and other items related to such agreement,
>
> (2) recharacterize any such items, or
>
> (3) make any other adjustment,
>
> if he determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper source and character of the taxable income (or any item described in paragraph (1) relating such taxable income) of each such person.

In this case, SUB and Insurer A are not related. It follows that section 845(a) may not apply unless it can be established that Insurer A was an “agent” or “conduit” between SUB and the Taxpayer. In regard to parties serving as conduits between related parties for purposes of section 845(a), the legislative history of section 845 provides:

> Treasury can use its recharacterization authority for a reinsurance agreement between unrelated parties where one of the parties to the agreement (with respect to any contract covered by the agreement), in effect, ... is a conduit between related persons. Thus, although one party may not have de facto control over the business of the other party (as required by section 482), it may have unilateral control over the profit levels for both parties with respect to specific lines of business covered by a reinsurance agreement, which can be used to distort the income of the parties.
>
> The Act also makes it clear that the allocation and recharacterization authority can be used with respect to related persons when one party to a reinsurance transaction acts as a conduit between the related persons. Whether a party is an agent of, or conduit between, other parties must be determined in light of all the facts and circumstances.

> An example of a fact that would tend to establish that an agency relationship existed is control on the part of the reinsurer over the amount of policyholder dividends that are paid by the reinsured .... This authority is generally similar to that provided under section 482 ... except that the authority extends to a broader class of items and may be exercised whenever it is necessary to reflect the proper character and source of the item.

Joint Committee on Taxation Staff, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 98^{th} Cong. 2d. Sess., at 634-635 (1984).

Based on this legislative history, the Service has authority to reallocate income between the Taxpayer and SUB under section 845(a). After forming SUB, the Taxpayer willingly reduced its sales commissions and no longer received retro refunds from Insurer A. The Taxpayer agreed to these reduced benefits without any material changes in the manner in which it offered the policies to its customers. Therefore, the parties appear to have negotiated a reduction in the Taxpayer's sales commissions and retro refunds in conjunction with a related agreement between SUB and Insurer A which effectively reallocated a portion of the sales commission and retro refunds to SUB. Insurer A was a conduit with respect to the commission payment because Insurer A was primarily concerned with its processing fee, and was not adversely affected by the reallocation of the Taxpayer's commissions and refunds to SUB. We conclude that this type of manipulation is contemplated by section 845(a). Accordingly, section 845(a) can be used to reallocate a portion of the reinsurance premium received by SUB to the Taxpayer because a portion of the premiums is actually a sales commission earned by the Taxpayer.

We note that the small life insurance deduction claimed by SUB is a tax preference item for purposes of the alternative minimum tax (Treas. Reg. Sec. 1.56(g)-1(d)(3)(ii)) and that SUB should not be able to file a consolidated return with the Taxpayer for five years (Sec. 1504(c)). We also note that a portion of the reinsurance premiums received by SUB from Insurer A may need to be capitalized and amortized under section 848. If SUB has not capitalized those amounts, Insurer A may be limited in its ability to reduce its policy acquisition expenses arising from policies reinsured with SUB under section 848. See Treas. Reg. sec. 1.848-2(g)(1).

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

In addition to developing the information discussed above, we suggest you consider the following before taking action on the points discussed above:

Sections 482 and 845

In *Commissioner v. First Security Bank*, 405 U.S. 394 (1972), the Supreme Court held that the Secretary's authority to reallocate income under section 482 was limited in situations where a federal law prevented the party performing the services from earning the income. The Taxpayer did not earn sales commissions on credit life insurance policies sold to customers in Virginia. The protest seems to indicate that the Taxpayer had contractually agreed to pay for the credit life insurance. However, some states, including Virginia, may prevent the Taxpayer from receiving a sales commission on credit life insurance. If so, this could limit our ability to reallocate income to the Taxpayer under sections 482 and 845(a).

* * * * *

Please call Steven Jensen at 202-622-3870 if you have any further questions.

JEFFREY L. DORFMAN