N. INSURANCE: THE RULE OF '86

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Part I: Background on Exempt Organizations' Insurance Activities

1. Outline of this Topic

Exempt organizations may engage in a variety of insurance-related activities without jeopardizing their exemptions. Since 1986, IRC 501(m) has limited the amount of outright "commercial-type insurance" activity in which section 501(c)(3) and section 501(c)(4) organizations may engage. IRC 501(e) was amended that year explicitly to allow hospital cooperative service organizations to purchase insurance on a group basis. Changes to IRC 501(c)(15) in the same year made it much easier for taxable organizations to create their own tax-exempt insurance companies. Section 501(c)(15) organizations may be either stock or mutual insurance companies (other than life), which generally engage in insurance activities of a commercial nature.

Part I of this article outlines the current status of the permissible insurance activities of section 501(c)(3) and section 501(c)(4) organizations in light of IRC 501(m), as well as a brief discussion of what insurance activity is now permitted for hospital cooperative service organizations under IRC 501(e). Part II describes current developments under IRC 501(c)(15) in detail, which necessarily entails a discussion of developments in insurance company and policyholder tax treatment on the taxable side.

Part II of this article describes IRC 501(c)(15) in greater detail. Part II discusses the 1986 IRC amendment, prior CPE articles, and current concerns over IRC 501(c)(15) exemption.

2. Prior CPE Articles Related to this Topic

Earlier CPE articles have discussed insurance activities of exempt organizations. Preceding the amendments to the Internal Revenue Code effected by the Tax Reform Act of 1986, an article appeared in the FY 1981 training materials. The article, "Insurance Activities of Exempt Organizations" (page 272) mainly dealt with group insurance programs of section 501(c)(6) organizations, however, there was some mention of section 501(c)(3) risk pooling trusts as well as methods used by those organizations to provide benefits to their employees.

The Tax Reform Act of 1986 added IRC 501(m) and amended IRC 501(c)(15). IRC 501(m) provides that organizations described in IRC 501(c)(3) and IRC 501(c)(4) may only be exempt from tax under IRC 501(a) if no substantial part of their activities consists of providing commercial-type insurance. IRC subsection 501(m)(3) describes specific types of insurance that are not "commercial-type insurance". IRC subsection 501(m)(2) prescribes that section 501(c)(3) and section 501(c)(4) organizations that are still exempt (*i.e.*, less than a substantial part of their activities consists of providing commercial-type insurance) treat the activity of providing commercial-type insurance as an unrelated trade or business under IRC 513, and treat themselves as insurance companies for purposes of applying Subchapter L with respect to the insurance activity.

After the 1986 Act changes to the Internal Revenue Code, a CPE article, "The Tax Reform Act of 1986" appeared in the FY 1987 materials (page 194) and included a section on insurance activities of exempt organizations affected by the 1986 Act. That section discussed the new sections of the Code added by the 1986 Act, IRC 501(m) and IRC 833, specifically as they affected Blue Cross and Blue Shield organizations, many of which were formerly organizations described in IRC 501(c)(4).

The Technical and Miscellaneous Revenue Act of 1988 amended IRC 501(e), which describes "cooperative hospital service organizations". That section lists permitted services that an organization may perform for two or more exempt hospitals on a cooperative basis and be treated as an organization described in IRC 501(c)(3). The 1988 Act added "(including the purchasing of insurance on a group basis)" after the previously listed permitted service of "purchasing".

The 1990 EO CPE included an article updating the unrelated business income tax (page 109), which included a section on insurance (page 128). That section mainly dealt with section 501(c)(5) and 501(c)(6) organizations offering insurance to their members.

3. <u>Pre-1986 Act Law</u>

A. <u>Single Exempt Organization Self-insuring</u>

Exempt organizations have long set aside funds to cover their own potential risks. The entities created and controlled by the exempt organizations to accomplish this have themselves been recognized as exempt. For instance, in Rev. Rul. 78-41, 1978-1 C.B. 148, an exempt hospital created a trust in which to accumulate and hold funds to be used to satisfy malpractice claims against the hospital. The ruling found that the trust was operating as an integral part of the hospital and performing a function that the hospital could do directly. It held that the trust was operated exclusively for charitable purposes and was exempt from tax under IRC 501(c)(3).

4. Current Law under IRC Sections 501(c)(3), 501(c)(4), and 501(m)

As mentioned in the previous description, IRC 501(m) bars exemption for organizations that would otherwise be recognized as exempt under sections 501(c)(3) and 501(c)(4) if a substantial part of their activities consists of providing commercial-type insurance. "Commercial-type insurance" is not defined in the IRC, but 501(m)(3) lists the following types of insurance that are *not* "commercial-type" for purposes of section 501(m):

(A)	insurance provided at substantially below cost to a class of charitable recipients;
(B)	incidental health insurance provided by a health maintenance organization of a kind customarily provided by such organizations;
(C) and (D)	property or casualty insurance, or retirement or welfare benefits, provided by a church or convention or association of churches for the organizations or their employees; and
(E)	charitable gift annuities.

General Explanation of the Tax Reform Act of 1986 also states that "commercial-type insurance does not include arrangements that are not treated as insurance (i.e., in the absence of sufficient risk shifting and risk distribution for the arrangement to constitute insurance)." (H.R. 3838, 99th Congress, Public Law 99-514, 585). The explanation then describes the fact pattern of Rev. Rul. 78-41 to illustrate such an arrangement. The longstanding Service position is that self-insurance (i.e., an organization setting aside reserves or funds itself to pay its future liabilities) by exempt organizations is not "commercial-type insurance". Entities created by exempt organizations for such a purpose generally continue to be recognized as exempt. (In fact, in general self-insurance is not insurance for tax purposes as discussed in Part II section B.)

For example, in GCM 39761 (October 24, 1988), a county government created a trust to provide workers' compensation benefits to its employees. Actuarial and separate accounting procedures were employed to determine contributions to the trust and to maintain the trust account. The GCM found that liability for workers' compensation claims was not shifted from the county to the trust, and therefore the arrangement did not constitute commercial-type insurance. The trust was recognized as exempt under IRC 501(c)(3) as an organization that lessens the burdens of government.

However, GCM 39703 (March 7, 1988) found that an organization created by a state's public high school athletic association to provide for the payment of certain health-care expenses of students injured during a school activity was not exempt under IRC 501(c)(4). Originally the corporation, created to reimburse high school students who were injured in school athletic events to the extent their health insurance did not cover them, was recognized as exempt under IRC 501(c)(4). The corporation gradually expanded the scope of its coverage to extend to all students of all schools of subscribing school districts for all approved school activities. IRC 501(c)(4) exemption was questioned on examination. The GCM found that tax exemption for the corporation was prohibited under IRC 501(m) because it provided commercial-type insurance, which was a substantial part of its activities.

Courts also have consistently found that "insurance pools" created by groups of tax-exempt organizations are not themselves exempt under IRC 501(c)(3) or IRC 501(c)(4) if they assume and distribute the pertinent risk to such an extent that they provide "commercial-type insurance". As insurance is usually the sole purpose and function of such an entity, it is a "substantial" part of its activities. Thus, these organizations cannot qualify as exempt under IRC 501(c)(3) or IRC 501(c)(4). Even if they could, they would violate IRC 501(m), which ultimately would prohibit their exemption. See Paratransit Insurance Corporation v. Commissioner, 102 T.C. 745 (1994) (exemption denied an organization providing automobile liability insurance to a group of section 501(c)(3) private social service entities that used automobiles to furnish transportation for the elderly, handicapped, and others); Nonprofits' Insurance Alliance of California, 32 Fed.Cl. 277 (Cl. Ct. 1994) (exemption denied a group self-insurance risk pool created as a mutual benefit corporation to provide automobile and miscellaneous professional liability coverages to tax-exempt organizations that operate, fund, or provide health or human services; did not meet IRC 501(m) "substantially below cost" exception). However, exemption under IRC 501(c)(15) may be possible. (See Part II for a comprehensive discussion of IRC 501(c)(15)).

The Service has recognized exemption under IRC 501(c)(3) of an organization whose principal activity is administering risk management funds for a group of exempt organizations where it found that the activity was related to the organizations exempt purpose of lessening the burdens of government. In TAM 9541003, a school board association created an organization to administer five cash/risk management funds. The funds were created for workers' compensation coverage; property, casualty and professional liability insurance; unemployment compensation; employee benefits; and cash management accounts, respectively. On examination, the Service found that the activities of the organization constituted a related business. The Service also stated that the facts did not support a concrete finding that the entity was providing commercial-type insurance and declined to make a 501(m) determination in the TAM.

5. IRC 501(e)

As noted in Section 2., above, the 1988 Act amended IRC 501(e) to permit cooperative hospital service organizations to purchase insurance on a group basis. The brief legislative history stated that "[t]he provision clarifies that the purchasing activities that may be carried on by a tax-exempt hospital service organization include the acquisition, on a group basis, of insurance (such as malpractice and general liability insurance) for its hospital members. The provision applies to purchases made before, on, or after the date of enactment." Technical and Miscellaneous Revenue Act of 1988 Conference Report (H.R. 4333, 100th Congress, 2d Session, Public Law 100-647, v. II, 209).

Revised IRC 501(6) does not sanction all insurance arrangements. The Eleventh Circuit recently affirmed a Tax Court decision in favor of the Service on an IRC 501(e) issue. In Florida Hospital Trust Fund v. Commissioner, 71 F.3d 808 (11th Cir. 1996), trust funds were established to serve as medical malpractice risk management trust funds or a group self-insurer fund for workers' compensation claims. Members of all three funds involved were exempt government or charitable hospitals. Member hospitals entered agreements to pool their respective risks and reciprocally self-insure. Exemption under IRC 501(c)(3) was denied all three funds based on their failure to satisfy both IRC 501(e) and IRC 501(m). In addition, all three funds were determined to be "feeders" under IRC 502. The Tax Court had found that the trust funds were not organized and operated exclusively for exempt purposes. 103 T.C. 140 (1994). In accordance with the Supreme Court's analysis in HCSC-Laundry v. U.S., 1 (1981), the enumerated activity requirement of IRC 501(e) should be strictly construed. In upholding denial, the Eleventh Circuit stated that "the member hospitals are not '*self*-insuring' themselves through these trusts. . . Neither are they 'purchasing' insurance on a group basis through these trusts . . . [Rather] . . . these member hospitals [are] *providing insurance to each other, on a reciprocal basis*, using trust vehicles as their chosen method of operation." 71 F.3d at 812, footnote omitted.

The Service has ruled that a group of employers that "jointly and severally" agree to pay premiums and set aside a cash reserve fund for workers' compensation claims could be taxed as an insurance company under IRC 831, even where the state called the arrangement "self-insurance". Rev. Rul. 83-172, 1983-2 C.B. 107. The arrangement in Rev. Rul. 83-172 was similar to the "group self-insurer fund for workers' compensation claims" in Florida Hospital Trust. As the following discussion will show, however, being an insurance company as described in Subchapter L does not prohibit tax exemption. IRC 501(c)(15) allows exemption of very small nonlife insurance companies. Changes made by the 1986 Act have made requirements for IRC 501(c)(15) exemption easier to meet, which has created the potential for abuse by taxable companies and their owners.

Part II: Issues Raised By IRC 501(c)(15)

A. Introduction

The 1986 Tax Reform Act of 1986 (the 1986 Act) liberalized IRC 501(c)(15) in two important respects. It allowed stock as well as mutual companies to qualify for exemption in an attempt to create parity between stock and mutual insurance companies, and it changed the measure of the dollar ceiling from a gross receipts test to a premium income test. (The changes are discussed in more detail in the 1989 CPE text at pp. 167-172.) IRC 501(c)(15) now provides that insurance companies (other than life) are exempt from federal income tax if their net written premiums (or if greater, direct written premiums) for the taxable 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 test.

The 1994 CPE article "The Blitz Since '86", explained the '86 Act in detail and presented an overview of the significant problem areas that have arisen as a result of the expansion of IRC 501(c)(15) to cover small for-profit insurance companies. The 1994 article covered the following areas:

(1) the various elements of an insurance contract, and the problems resulting from extended service contracts/warranties;

(2) the nature of captive insurance companies and how to identify sham companies;

(3) the problem of companies in liquidation;

(4) the dynamics of the $350,000 test, and the related areas of IRC 845 and 1563; and

(5) the life insurance company prohibition.

The changes to IRC 501(c)(15) resulted in a dramatic increase in the number of exemption applications filed under that section. We now average receipt of almost 100 applications per year, whereas before 1987 we averaged approximately two applications per year.

Some of the IRC 501(c)(15) applicant organizations only underwrite or reinsure risks from businesses in which their shareholders have a controlling or financial interest. Such businesses usually, in connection with either the financing or the sale/rental of various goods and products like automobiles, VCRs, etc., sell either credit life and credit accident and health (A&H), or service/warranty contracts.

B. Risk Shifting and Risk Distribution

(1) Background

To qualify for recognition of exemption under IRC 501(c)(15), an organization's primary and predominant activity must be that of an insurance company engaged in the business of issuing and servicing insurance contracts. An insurance contract must shift and distribute a risk of loss, and that risk must be an "insurance" risk, as stated in Helvering v. LeGierse, 312 U.S. 531 (1941).

The Service currently makes a sharp distinction between risk shifting and risk distribution. Simply put, risk shifting requires that a risk pass away from the insured to the insurer. Risk distribution requires the pooling by the insurer of a number of independent risks.

The Service has a longstanding position that "self- insurance" arrangements do not involve risk shifting or risk distribution and, therefore, are not insurance. Thus, a business cannot set aside a fund as an "insurance" reserve and claim a business expense deduction for insurance premiums paid under IRC 162 and Reg. 1.162-1(a). *See* Anesthesia Service Medical Group, Inc. v. Commissioner, 825 F.2d 241 (9th Cir. 1987) and Spring Canyon Coal Co. v. Commissioner.

(2) "Captive" Reinsurers

Risk shifting issues frequently arise in the case of captives. In Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), the court defined a "captive", in footnote 1 on page 1298, as

> a corporation organized for the purpose of insuring the liabilities of its owner. At one extreme is the case presented here, where the insured is both the sole shareholder and only customer of the captive. There may be other permutations involving less than 100% ownership or more than a single customer, although at some point the term "captive" is no longer appropriate.

In Rev. Rul. 77-316, 1977-2 C.B. 53, as <u>amplified and clarified by</u> Rev. Rul. 88-72, 1988-2 C.B. 31, and Rev. Rul. 89-61, 1989-1 C.B. 75, the Service addressed whether a subsidiary which "insured" the risks only of its parent and the parent's other subsidiaries was an insurance company for tax purposes. The Service concluded that the economic reality of the situation was that the insurance agreement with each subsidiary was designed to obtain a deduction for the parent and its other subsidiaries by indirect means that would be denied if sought directly (with a fund set aside for self-insurance). The parent, its "insurance" subsidiary, and its other subsidiaries, though separate corporate entities, represent one economic family, with the result that those who bore the ultimate economic burden of loss were the same persons who suffered the loss. Thus, there was no economic shifting or distributing of risk of loss to the extent that the risks were not retained by an unrelated insurance company. The Service reasoned that since the offshore captive was not an insurance company, the payments by the parent and the other subsidiaries were not deductible as business expenses under Reg. 1.162-1(a), and the payments were not income to the offshore captive from the conduct of a business, but were capital contributions. Thus, payments made by the offshore captive were dividends to the extent of its earnings and profits.

However, in Rev. Rul. 78-338, 1978-2 C.B. 107, the Service concluded that since a foreign insurance company's 31 shareholders, who were the company's only insureds, were not economically related, the economic risk of loss was shifted and distributed among the shareholders, thus insurance payments made by the U.S. shareholders were deductible as ordinary business expenses under IRC 162.

Rev. Rul. 88-72, 1988-2 C.B. 31, <u>clarified by</u> Rev. Rul. 89-61, 1989-1 C.B. 75, explains the difference between risk shifting and risk distribution. Risk shifting occurs where a risk is shifted away from a corporate parent and its subsidiaries. Risk distribution occurs when an insurance company accepts a large number of independent risks, and thereby takes advantage of a statistical phenomenon known as the "law of large numbers." Although the potential loss exposure increases, the average loss incurred becomes increasingly predictable.

(3) Deductibility of Premium Cases

There have been a number of court decisions involving whether amounts paid to an offshore captive are deductible under IRC 162, and whether the contracts issued by the offshore captive are insurance or annuity contracts within the meaning of Reg. 1.801-3(a)(1). *See, e.g.*, Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981), cert. denied, 454 U.S. 965 (1981); Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985); Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1986); and Clougherty Packing Co., supra. Some of the fact patterns in these court cases are virtually indistinguishable from the fact pattern in Rev. Rul. 77-316. In such cases the courts have usually upheld the government's position that such contracts are not contracts of insurance. However, no court has expressly adopted the Service's economic family doctrine espoused in Rev. Rul. 77-316.

As discussed in the 1994 CPE article on IRC 501(c)(15), taxpayers have won several cases on fact patterns falling somewhere between those of Rev. Rul. 77-316 and Rev. Rul. 78-338. Several courts have held, contrary to Rev. Rul. 88-72, that substantial insurance business with unaffiliated insureds creates a pool allowing for risk shifting as well as risk distribution with regard to premium payments by a parent to its insurance subsidiary. See Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135 (Fed. Cir. 1993) (44-66% unaffiliated business); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992) (52-74% unaffiliated business); The Harper Group v. Commissioner, 979 F.2d 1341 (9th Cir. 1992) (29-33% unaffiliated business); and Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858 (7th Cir. 1992) (99% unaffiliated business).

In Humana Inc. and Subsidiaries v. Commissioner, 88 T.C. 197 (1987), affirmed in part and reversed in part sub nom Humana Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989), the Sixth Circuit affirmed the Tax Court's finding that the parent's insurance payments on its own behalf were not deductible insurance premiums. However, the Sixth Circuit overruled the Tax Court in favor of the appellant with regard to the payment of insurance premiums by its other subsidiaries, finding such payments to be insurance premiums deductible by the subsidiaries.

In Gulf Oil Corp. v. Commissioner, 914 F.2d 396 (3d Cir. 1990), the facts showed that Gulf formed a Bermuda subsidiary with $120,000 capitalization. Gulf and its affiliates purchased insurance from commercial carriers who reinsured their risks with the Bermuda subsidiary. Gulf executed agreements with the unrelated carriers guaranteeing indemnification in the event of default by the Bermuda subsidiary. The Third Circuit distinguished the Gulf situation from Humana in disallowing the deduction for the premiums paid by Gulf and its affiliates. Unlike Humana, Gulf formed a thinly capitalized foreign insurance captive and the parent company entered into indemnification agreements with the unrelated insurers.

Some courts, even though not expressly adopting the economic family doctrine, have issued decisions favorable to the Service on economic factors other than the relationship between the insured and the insurer. These economic factors include whether there is a legitimate business purpose for the establishment of the offshore insurance company; whether the offshore insurance company is thinly capitalized; and whether the offshore's parent has furnished a guarantee to unrelated primary insurers of the performance of the offshore insurance company.

For example, in Malone & Hyde Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995), the facts showed that Malone & Hyde (MH) formed an offshore insurance subsidiary, Eastland Insurance, Ltd. (EIL), to reinsure the first $150,000 coverage of the insurance MH obtained from Northwestern National Insurance Company (NNIC) for itself and its subsidiaries. In 1989 the Tax Court held MH was not entitled to a section 162 deduction for the premium payments made to NNIC that were reinsured with EIL. Malone and Hyde, Inc. and Subsidiaries v. Commissioner, T.C. Memo 1989-604. Because of the intervening Humana decision by the Sixth Circuit, the Tax Court agreed to a rehearing of Malone and Hyde. T.C. Memo 1993-585. The Service argued that the hold harmless agreements, irrevocable letters of credit, and EIL's thin capitalization distinguished the subject organization in Malone & Hyde from the subject organization in Humana. The Tax Court found in favor of MH on the brother-sister subsidiary issue, and, with respect to the section 162 deductibility issue, followed the three part test from AMERCO, Sears, and The Harper Group, supra, for determining whether a transaction involves insurance for income tax purposes. The three part test concerns (1) whether the transaction involved "insurance risks"; (2) whether there is risk shifting and risk distribution; and (3) whether there is insurance in its commonly accepted usage.

On appeal, the Sixth Circuit concluded that the Tax Court should have first determined whether MH created EIL for a legitimate business purpose, or determined whether EIL was a sham corporation. The Sixth Circuit concluded that MH had no legitimate business reason for establishing EIL, whereas in the Humana case, Humana could not obtain insurance in the open market and thus had a legitimate reason for establishing a controlled captive. Further, the Sixth Circuit concluded that EIL was thinly capitalized, which had not been the case in Humana. The Sixth Circuit held that EIL, a thinly capitalized captive foreign subsidiary, was a sham corporation propped up by its parent, MH. The Sixth Circuit in Malone & Hyde distinguished Gulf Oil from Humana, and reasoned that the result in Humana would have been different if Humana had set up a thinly capitalized foreign captive and entered into indemnification agreements with unrelated insurers. The court found the MH facts to be more similar to Gulf Oil than to Humana. The court concluded that even though the foreign subsidiary (EIL) met the minimum capitalization requirements of its country of incorporation, there was no risk shifting. Thus, since there was no shifting and distribution of the risk of loss to unrelated parties, there was no insurance.

As indicated in the 1994 article, the Service ordinarily will not rule on whether the risk shifting and distribution necessary to constitute insurance are present for purposes of determining if a company is an "insurance company" under Reg. 1.801-3(a), unless the facts are within the scope of Rev. Rul. 77-316 or 78-338. Rev. Proc. 96-3, 1996-1 I.R.B. 82, 90, sec. 4.39.

If an IRC 501(c)(15) applicant's insurance or reinsurance contracts lack the necessary elements of risk shifting and risk distribution, then the applicant fails to qualify as an insurance company, and therefore fails to qualify under IRC 501(c)(15). Generally, an applicant's reinsurance contracts contain the necessary elements of risk shifting and risk distribution where the risks involved are credit life or credit disability risks. The Service's captive analysis in Rev. Rul. 77-316, does not apply to credit insurance contract cases because the producer of the credit insurance, which is reinsured by the applicant, only sells credit insurance contracts written by unrelated third party issuers, and is not the insured under such contracts. However, where the producer and the applicant are controlled by the same persons, and the producer issues extended service contracts which are clearly its own risks and these are the only risks "reinsured" by the IRC 501(c)(15) applicant, then it is more likely that the Service may successfully assert the captive analysis (commonly referred to as the economic family doctrine) under Rev. Rul. 77-316 to reach a conclusion that the applicant is not engaged in the insurance business.

Even though the courts have ruled unfavorably on the economic family doctrine, the Service will litigate some cases involving the factors of Malone & Hyde. The Service will be selective with respect to using a "sham corporation" theory for offshore captives. The "sham corporation" issue or argument may be more successful (or more likely in fact) where offshore captives, rather than domestic captives, are involved.

Inadequate capitalization is a major symptom of a sham corporation as reflected in Malone & Hyde. The pre-Humana line of cases, Carnation and Beach Aircraft, supra, involved the issue of an undercapitalized captive, however, the Service did not raise the sham corporation issue in these cases. The Humana case distinguished these cases in discussing the inadequate capitalization issue. Further, the Humana court stated that "[a]bsent a fact pattern of sham or lack of business purpose, a court should accept transactions between related but separate corporations as proper and not disregard them because of the relationship of the parties." It is currently felt that more corporate groups with an insurance subsidiary are set up like the Malone & Hyde family, while the specific facts of Humana represent the unusual case.

C. Sham Corporations

(1) Common Offshore Captive Uses in IRC 501(c)(15) Context

In addition to reinsurance companies formed by owners of automobile dealerships, in the last two years we have received a number of applications from offshore reinsurers established by owners of loan companies, auto rental companies, TV and VCR rental companies, and other property rental companies.

The automobile dealerships, loan companies, auto rental companies, TV and VCR rental companies, and other property rental companies (hereafter collectively referred to as the Producers) sell credit life, credit A&H, and extended service/warranty contracts to their customers. Under most state jurisdictions, the extended service/warranty contracts are not contracts of insurance, however, state law characterization of such an arrangement is not controlling for federal tax purposes. See e.g., Rev. Rul. 83-172, supra, (40 member self-insurance group considered an insurance company for federal income tax purposes). The 1994 CPE article sets out a fact pattern with respect to applicant organizations seeking exemption under IRC 501(c)(15). Usually, the applicant organization is a reinsurance company, incorporated in a foreign jurisdiction, and owned by a Producer, or by the Producer's owners, officers, or directors. The applicant foreign reinsurer usually has no paid employees and no property of its own other than a bank account and a ledger. Sometimes the applicant's place of business is the headquarters of the Producer. Some applicant foreign reinsurers hire an Administrator to receive communications and to perform certain clerical and administrative functions.

With respect to credit life and credit A&H insurance contracts, a Producer acts as an agent for the direct writer when he/she sells an insurance contract to a customer. With respect to extended service/warranty contracts, a Producer generally will contract with an Administrator, who will furnish it with the service/warranty agreements and promotional material to distribute to the Producer's customers. The Producer or the Administrator then will purchase an insurance contract from a "fronting company", which will insure the Producer's liability under the extended service/warranty contract.

By prearrangement with the Producer, the fronting company keeps the premiums necessary to underwrite the risk, and sometimes keeps an administrative fee, and then passes the remaining premiums on to the offshore reinsurer. The Administrator of the service contracts keeps an administrative fee of 10 to 15 percent.

The offshore reinsurer establishes a reserve fund for the payment of insurance claims and invests the funds. Generally, no claim is ever made on the reserve fund since all claims are usually processed and paid by the fronting company with current premiums. It appears that the offshore reinsurer's primary function is to hold the profits from the sale of insurance or service contracts and to make distributions or loans to its shareholders.

Generally, the characteristics of a sham company are that it has no business address, paid employees, or property other than a ledger and bank account. *See* Shaw Constr. Co. v. Commissioner, 35 T.C. 1102 (1961), aff'd, 323 F.2d 316 (9th Cir. 1963); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582 (1959). See also Kimbrell v. Commissioner, 371 F.2d 897 (5th Cir. 1967). Such characteristics may, or may not be present in an offshore insurer, or reinsurer. However, the critical factors with respect to an offshore insurer, or reinsurer is whether such entity assumes and distributes risk.

(2) Business Purpose Cases

When organizations that have the characteristics of a sham company, as described in the paragraph above, apply for exemption under IRC 501(c)(15), the Service may treat them as sham corporations and deny exemption. In Wright v. Commissioner, T.C.M. 1993-328 (July 26, 1993), the Service sought to treat certain reinsurers as sham corporations, conducting no business and having no purpose other than sheltering their shareholders' income. In the alternative, the Service sought to treat the reinsurance arrangement as self-insurance by the dealership and to recharacterize the income under IRC 845(a) or IRC 482.

In Wright, a foreign corporation, First Interstate Re, Inc. (FIR), "reinsured" credit insurance contracts sold by auto dealerships owned by the owner of FIR, and received the profits from service contracts sold by the dealerships. The Tax Court held that FIR was a sham, formed to avoid tax on income earned by the dealerships. The court based its decision on the following circumstances: the dealerships requested a reduction in sales commissions (below the state maximum on sales commissions) which diverted income to FIR; FIR set up greater reserves than those mandated by state law, which had the effect of understating income; the dealerships failed to report their profits on the sales of service contracts above cost, but funneled such profits through the service contract administrators to FIR through overstatement of the dealer cost, without any contractual agreement with FIR; FIR's shareholder failed to keep FIR's funds separate from the dealerships, taking numerous distributions and loans from FIR, and replacing funds in its custodial account with a letter of credit from one of the dealerships; FIR had no offices, furniture, or equipment; FIR was capitalized with only $1000; some of the dealerships that sold contracts reinsured by FIR were not listed in FIR's reinsurance agreement; and although FIR purported to reinsure contracts sold by unrelated entities for several years, it was unable to substantiate that such unrelated business existed.

The court distinguished the Wright situation from Alinco Life Ins. Co. v. United States, 373 F.2d 336 (Ct. Cl. 1967), on the grounds that in Wright, the dealerships received less commission than allowed by law; that FIR was not a qualified insurance company under state law and did not keep appropriate reserves; and that the only insurance policies reinsured by FIR were those sold by the related dealerships.

The Wright court also found two instances in which the purported "insurance" failed to shift and distribute risk and thus failed to qualify as insurance for federal tax purposes:

First, with regard to the "reinsurance" by FIR of the credit insurance contracts sold by the auto dealerships, the court reasoned that the dealerships were in effect the insureds under the credit policies, and a brother company (FIR) was the insurer. The court noted that FIR insured no unrelated business, and that one of the dealerships issued a letter of credit to the primary insurer.

Second, the court held that there was no risk shifting or distribution with regard to annuities purchased by an unrelated insurer of service contracts sold by the dealerships. Each annuity was used only for a single dealership's liabilities, the dealerships received the interest earned on the annuities, and the dealerships were entitled to the balance of the annuity proceeds after the service contracts expired. These decisions in the Wright case were appealed to the Ninth Circuit.

The Tax Court modified the above decision in the Wright case by Order dated October 29, 1993, to, in effect, correct the inference that "the [Wright] dealerships were in effect the insureds under the credit policies".

On appeal (William T. and Lynne L. Wright, et. al. v. Commissioner 76 A.F.T.R.2d 95-8096 (9th Cir. 1995)), the Ninth Circuit found that there was ample evidence to support the Tax Court's findings that the taxpayers formed a sham reinsurance company to avoid taxes, fraudulently understated income, and claimed erroneous deductions and false annuity payments.

As indicated above in Malone & Hyde, the Sixth Circuit concluded that MH had no legitimate business reason for establishing EIL, whereas in the Humana case, Humana could not obtain insurance in the open market and thus had a legitimate reason for establishing a controlled captive. Further, the Court concluded that even though EIL, the foreign subsidiary, met the minimum capitalization requirements of its country of incorporation, there was no risk shifting. Since there was no shifting or distribution of the risk of loss to unrelated parties, there was no insurance.

D. Controlled Groups

The 1994 CPE article on IRC 501(c)(15) contained a lengthy discussion of the term "controlled corporations". As noted in the discussion, the term "controlled group" is defined in IRC 831(b)(2)(B)(ii), which in turn employs the definition of "controlled group of corporations" in IRC 1563(a), with certain modifications. IRC 501(c)(15)(B) provides for the aggregation of the net and direct written premiums received during the tax year by all other companies or associations which are members of the same controlled group. IRC 501(c)(15)(C) provides that for purposes of subparagraph (B), the term controlled group has the meaning given such term by IRC 831(b)(2)(B)(ii).

IRC 831(b)(2)(B)(ii) provides that:

> [f]or purposes of clause (i) the term 'controlled group' means any controlled group of corporations (as defined in section 1563(a)); except that -
>
> (I) 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in section 1563(a), and
>
> (II) subsections (a)(4) and (b)(2)((D) shall not apply.

Please note that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" each place it appears in section 1563(a). The 1994 CPE article erroneously quoted the phrase as "at least 50 percent".

As indicated in the 1994 CPE article, IRC 1563(a) provides for three types of controlled groups: parent-subsidiary, brother-sister, and combined. Hypothetical examples of these types of controlled groups were set out in the 1994 article.

We see the brother-sister type of group most. To determine whether two corporations are brother-sister corporations, we must apply the constructive stock ownership rules under IRC 1563(a).

IRC 1563(a)(2) defines the term "brother-sister controlled group" to mean:

> [t]wo or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing-- ... (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each corporation.
>
> IRC 1563(d)(2)(B) states that:
>
> [f]or purposes of determining whether a corporation is a member of a brother-sister controlled group of corporations ... stock owned by a person who is an individual, estate, or trust means (A) stock owned directly by such person, and (B) stock owned with the application of subsection (e).

IRC 1563(e)(5) states, in pertinent part, that an individual shall be considered as owning stock in a corporation owned directly or indirectly by or for his spouse.

IRC 1563(e)(6)(A) states, in pertinent part, that an individual shall be considered as owning stock owned directly or indirectly by or for his children who have not attained the age of 21 years; and if the individual has not attained the age of 21 years, the stock owned directly or indirectly by or for his parents.

IRC 1563(e)(6)(B) states, in pertinent part, that an individual who owns 50 percent or more of the shares of stock in a corporation shall be considered as owning the stock in such corporation owned directly, or indirectly by or for his parents, grandparents, grandchildren and children who have attained the age of 21 years.

Three hypothetical situations follow that illustrate application of the constructive stock ownership rules set out above.

SITUATION I

Two brothers **A** and **B** each own 50% of a Producer, which sells credit life, credit A&H and service warranty contracts to its customers. **A** has a 50% interest in **X**, an offshore insurance company, and a Family Trust in which **A** is the beneficiary owns the other 50% of **X.** **B** has a 50% interest in **Y**, an offshore insurance company, and a Family Trust in which **B** is the beneficiary owns the other 50% of **Y.** **X** and **Y** each reinsure 50% of the service warranty contracts sold by the Producer. **A** and **B** each own 50% of **Z** an offshore insurance company, that reinsures the credit life and credit A&H sold by the Producer. Because **A** has no interest in **Y**, and because **B** has no interest in **X**, then pursuant to IRC 1563, **X**, **Y** and **Z** are not controlled corporations within the meaning of IRC 1563.

SITUATION II

A son and mother, **S** and **M** each own 50% of **O**, an offshore insurance company. **S** and his wife **W**, and **M** and her husband **H**, each own 25% of **P**, a Producer which sells service warranty contracts to its customers. Because **S** and **W** are husband and wife, and because **M** and **H** are husband and wife, under IRC 1563(e)(5) **S** is treated as owning **W**'s shares in **P**, and **M** is treated as owning **H**'s shares in **P**. Thus, both **S** and **M** are each treated as owning 50% of **P**. **O** and **P** are controlled corporations within the meaning of IRC 1563.

SITUATION III

N owns 100% of **K**, an offshore insurance company. **K** only insures **T**. **N** and **T**'s sole owner is **P**. This is an example of a combined group. A diagram of this relationship would reflect the following:

Individual (P)

100% — N Corporation

100% — T Corporation

N Corporation

100% — K Corporation

N, **K**, and **T** are members of a combined group.

E. Current Developments

(1) Tax-avoidance Reinsurance Transactions

The 1994 CPE article discussed the implications of IRC 845(b), which authorizes the Secretary to make proper adjustments, in the case of any reinsurance contract having a significant tax avoidance effect, to eliminate the tax avoidance effect with respect to a party to the contract.

For example, the 1994 CPE article referred to TAM 9308003, in which the Service ruled that two reinsurance agreements had a significant tax avoidance effect, and therefore disregarded them in determining whether the reinsurance company qualified as a life insurance company. The reinsurance assumed had the effect of increasing the life reserves to greater than 50% of total reserves, and thus would have allowed the company to be taxed as a life insurance company had the reinsurance contracts not been disregarded.

In a court opinion dated April 30, 1996, in Trans City Life Insurance Company v. Commissioner, 106 T.C. No. 15, the Tax Court cited the Deficit Reduction Act of 1984 conference report (H.R. Conf. Rep. No. 861, 98th Cong., 1st Sess. 1062 (1984), 1984-3 C.B. 316) wherein it was stated that "[a] tax avoidance effect must be significant to one or both of the parties to a reinsurance agreement in order for the Commissioner to exercise her authority to make adjustments under section 845(b)." Further, the DEFRA conference report stated that a tax avoidance effect is significant "if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties." The DEFRA conference report then set forth seven factors that help determine an agreement's economic substance. These factors include the following:

(a) the age of the business reinsured (reinsurance of a new block of insurance contracts has more economic substance than an old block);

(b) the character of the business reinsured (reinsurance of long-term insurance has more economic substance than short-term);

(c) the structure for determining the potential profits of each of the parties, and any experience rating;

(d) the duration of the reinsurance agreement;

(e) the parties' rights to terminate the reinsurance agreement, and the consequences of a termination;

(f) the relative tax positions of the parties; and

(g) the general financial situations of the parties.

In the opinion of Trans City, supra, the Tax Court discussed each of the above seven factors. Additionally, the Tax Court discussed an eighth factor, "risk transferred versus tax benefits derived", and a ninth factor, "state determinations". We are not sure what relative merit should be given to the eighth and ninth factors since they were not part of the DEFRA conference report.

In conclusion, the Tax Court ruled that IRC 845(b) is not unconstitutionally vague and that the Commissioner may rely upon IRC 845(b) prior to the issuance of regulations. However, the Tax Court concluded that the factors showed that the agreements in the Trans City case did not have a "significant tax avoidance effect" within the meaning of IRC 845(b).

The significance of Trans City is that IRC 845(b) has been ruled not to be unconstitutionally vague and that the Commissioner may rely upon IRC 845(b) prior to the issuance of regulations. The Service has not made a decision on what action to take in the Trans City case.

(2) Administration's Fiscal 1997 Budget Proposal - Captive Insurance Company Provisions

President Clinton's proposed fiscal 1997 budget includes provisions reforming the tax treatment for captive insurance arrangements. The proposed legislation creates a new code section, IRC 849, and includes a restriction on IRC 501(c)(15) exemption. The proposed legislation of March 1996 would amend Subchapter L (Insurance Companies) and Subpart F (Controlled Foreign Corporations) provisions, as well as IRC 501(c)(15).

a. Current Tax Treatment of Foreign Captives and their Domestic Shareholders

IRC sections 951 through 964 comprise Subpart F - Controlled Foreign Corporations. IRC 957(a) defines CFCs as foreign corporations in which more than 50 percent of the total combined voting power of all classes of stock or of the total value of the stock of the corporation is owned by United States shareholders on any day of the CFC's taxable year. The definition also includes corporations in which more than 25 percent of the total combined voting power of all classes of stock, or more than 25 percent of the total value of the stock is owned directly, indirectly or constructively by U.S. shareholders if the gross amount of premiums with respect to the issuing or reinsuring of an insurance or annuity contract exceeds 75 percent of all premiums.

IRC 951(a)(1)(A) provides that a U.S. shareholder of a CFC must include in gross income his *pro rata* share of the CFC's Subpart F income for the year, even if not distributed. IRC 952(a) defines the term "Subpart F income" to include "insurance income" and "foreign base company income" of the U.S. shareholder.

Pursuant to IRC 953, insurance income is income attributable to the issuing or reinsuring of any insurance or annuity contract that covers risks located outside the CFC's country of incorporation, which would be taxed under Subchapter L (Insurance Companies) if the CFC were a domestic company. IRC 953(b) makes certain adjustments to the normal Subchapter L rules, and IRC 953(c) prescribes special rules for certain captive insurance companies. IRC 953(d) allows an election by a foreign insurance company to be treated as a domestic corporation.

IRC 954(a)(1) defines foreign base company income to include foreign personal holding company income. IRC 954(c)(1)(A) includes dividends, interest, royalties, rent and annuities in foreign personal holding company income.

b. Administration's Proposed Changes

The March 1996 legislative proposal would amend Subchapter L rules to treat as derived from a business other than insurance amounts paid as "premiums" by large shareholders (or persons related to large shareholders) from the calculation of insurance premiums in applying a "primary and predominant business activity" test, which would be used to determine whether the captive is an insurance company. If a captive qualifies as an insurance company under this "primary and predominant business activity" test, premiums paid to the captive by its shareholders for *bona fide* insurance would be deductible to the extent that such amounts are deductible under current law.

If, however, a captive failed to qualify as an insurance company under the primary and predominant business activity test, amounts paid as "premiums" by its large shareholders (or persons related to its large shareholders) would not be deductible to them and would be excluded from the captive's gross income, and the captive would not be subject to Subchapter L. However, premiums paid by small shareholders or unrelated policyholders would continue to be deductible and would continue to be included in the captive's gross income. IRC 501(c)(15) would explicitly be made inapplicable to persons not treated as insurance companies under the new IRC 849 described above.

It is currently unclear if, when, or in what final form provisions reforming the captive insurance company area will become law.

(3) Subpart F Implications for Exempt Organizations

Under the current law of Subpart F, if exempt organizations are U.S. shareholders with respect to Controlled Foreign Corporations (CFCs), there may be an issue of whether the Subpart F income is unrelated business taxable income (UBTI). IRC 511 imposes the corporate rate tax on the UBTI of exempt organizations. IRC 512(a) generally defines UBTI, and IRC 512(b)(1) excludes dividends, interest, payments with respect to securities loans, and several other items of income from UBTI. IRC 512(b)(13) requires that interest, annuities, royalties, and rents derived from an organization controlled by a controlling exempt organization must be included in income. Thus, whether a Subpart F exclusion is UBTI depends upon how it is characterized. Rulings issued by the Service have adopted one of two separate approaches for characterizing a Subpart F inclusion for UBTI purposes.

Under one approach, the Subpart F inclusion is treated as a dividend. For example, in PLR 9024086 (March 22, 1990) an exempt organization's wholly owned insurance company derived investment income from international arbitrage transactions, which was Subpart F income. The ruling held that the Subpart F income was excluded from UBTI under IRC 512(b)(1). The ruling stated that the Subpart F inclusion would be treated as if it were a dividend for UBTI purposes. With dividend treatment the income would not be subject to the "controlled organization" income inclusion rules of IRC 512(b)(13).

The other approach is a look-through approach. Under this approach the Subpart F inclusion is UBTI only to the extent the Subpart F income would have been UBTI if earned directly by the tax-exempt entity. PLR 9043039 (July 30, 1990) ruled that the CFC was not an insurance company for tax purposes because it only self-insured the controlling exempt organization. Therefore, the ruling letter concluded, the CFC's "premium" income is not treated as insurance income for Subpart F, but rather is treated as contributions of capital under IRC 118. The CFC's Subpart F income therefore consisted entirely of investment income. Under the look-through approach, if the tax-exempt entity had earned the income directly it would have been excluded from UBTI. Therefore, the Subpart F income was excluded under IRC 512(b)(1) and IRC 512(b)(5) for UBTI purposes.

The last letter considering this UBTI issue, PLR 9407007 (November 21,1993), looked at whether "premiums" the tax exempt parent paid to its captive constituted UBTI to the parent. That letter ruled that there was no "insurance" under the arrangement. The payments were treated as a dividend for purposes of the UBTI exclusion. The letter did not rule on the treatment of the captive's investment income. Based on the apparent return to the "dividend theory", it is probably not advisable to set up cases on the look-through theory at this time.

(4) <u>More Proposed Legislation Affecting Other Exempt Organizations' Insurance Activities</u>

A statutory provision for the exemption of state-sponsored organizations providing health coverage for high-risk individuals is included in the Senate-passed version of the Health Insurance Reform Act, H.R. 3103 (S. 1028). The legislation creates a new exemption section, 501(c)(26), for membership organizations established by states exclusively to provide coverage for medical care on a not-for-profit basis to certain individuals, either through insurance issued by the organization or a health maintenance organization. The individuals covered by these "high-risk pools" must be state residents unable to acquire medical care coverage, or able to acquire that coverage at an excess rate only, for certain medical conditions. The net earnings of the organization cannot inure to the benefit of any private shareholder or individual. The provision would be effective for taxable years beginning after 1996.

(5) Summary

The 1994 CPE Article summarized various qualification requirements areas that must be examined when considering whether to grant exemption under IRC 501(c)(15), or when considering whether exemption under IRC 501(c)(15) should be continued or revoked. Specifically, the following qualification requirements should be considered:

(i) To be exempt under IRC 501(c)(15), an organization's primary business must be the issuance of insurance contracts or reinsurance of risks, or the servicing of liquidating claims if the organization is in liquidation;

(ii) Certain applicant organizations, such as organizations that primarily reinsure service contracts and/or seller's warranties issued by related Producers, might not be considered insurance companies because of a lack of risk shifting and risk distribution, which would disqualify them from exemption under IRC 501(c)(15);

(iii) Under some circumstances reinsurers of insurance contracts, which are sold by related persons, may be regarded as sham corporations, which will disqualify them from exemption under IRC 501(c)(15);

(iv) Applicant organizations which receive more than $350,000 in net written or direct written premiums (including premiums of the members of any controlled group) are disqualified from exemption under IRC 501(c)(15); and,

(v) Applicant organizations that are life insurance companies, as defined in IRC 816, are disqualified from exemption under IRC 501(c)(15).

As previously noted, the owners of other types of businesses, in addition to automobile dealerships, have established offshore insurance companies to reinsure the insurance contracts sold by their businesses. These businesses include loan companies, auto rental companies, TV and VCR rental companies and other rental companies. When examining the corporate returns of such businesses, an agent should inquire about the interest of the business owner in any offshore insurance company.

If the business owner has an interest in an offshore insurance company, information about the status of such offshore insurance company under IRC 501(c)(15) and its election under IRC 953 should be obtained. If the offshore insurance company is exempt under IRC 501(c)(15), consideration should first be given to whether it continues to meet the threshold requirements for exemption. Secondly, it should be determined whether the contracts the offshore insurance company reinsures are, in effect, contracts of insurance.

If the offshore insurance company meets the threshold requirements for exemption under IRC 501(c)(15), and the contracts which it reinsures are purportedly contracts of insurance, then consideration should be given to whether there is any shifting or distribution of the risk from the insured to the insurer.

In addition, it should be determined whether there was a legitimate business purpose for establishment of the offshore insurance company. The factors present in the Malone & Hyde and Wright cases should be scrutinized to determine whether there was a legitimate business purpose for the formation of the offshore insurance company. It should be kept in mind that Wright is fact sensitive and that Malone & Hyde is the preferred case for this issue.

If the offshore insurance company has the characteristics of a "sham company" (no business address, paid employees, or property other than a ledger and bank account) and otherwise comes within Malone & Hyde and Wright, proposed revocation under IRC 501(c)(15) may be in order.

The constructive ownership rules under IRC 1563 should be used to consider whether the Producer of the insurance products and the offshore reinsurance company are "brother-sister" corporations.

When an agent concludes that there is a significant tax avoidance effect with respect to a reinsurance agreement, and gives consideration to making adjustments as provided for in IRC 845(b), the agent should critically analyze the pertinent facts to determine whether there is any economic substance to the agreement. This should be accomplished by determining whether any or all of the factors set out in Trans City are present in the case, specifically the seven factors contained in the DEFRA conference report.

If the agent decides that exemption should continue, consideration should be given to whether any of the CFC's Subpart F income is UBTI as discussed in Part II, section E.(3).

Finally, if the Administration's proposed changes (as set out in Part II, section E.(2)(b)) with respect to the treatment of CFCs is enacted, these changes would effect exemption under IRC 501(c)(15) of most, if not all CFCs, and could result in the prospective revocation of many current CFCs exempt under IRC 501(c)(15).