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

OFFICE OF
CHIEF COUNSEL

March 31, 2000

Number: **200026016**
Release Date: 6/30/2000
CC:INTL:Br5/WTA-N-109505-99
UILC: 845.00-00
482.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR CHIEF, NORTHERN FLORIDA APPEALS OFFICE
Att.

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

SUBJECT:

This Field Service Advice responds to your memorandum dated March 12, 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

State X =
Appeals Officer =
Taxpayer =
SUB =
Insurer A =

Country A =
Date Q =
$AA =
$BB =

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 a retail establishment that is primarily engaged in the "rent-to-own" business. Customers lease or "rent-to-own" property from the Taxpayer by signing a written contract called a Rental-Purchase Agreement (the "Rental Contract"). The Rental Contract states that the customer is responsible for the property and that the customer must provide proof of adequate insurance or must purchase property insurance through the Taxpayer. Customers almost always buy insurance from the Taxpayer. It is our understanding that customers can buy property insurance from an insurance company for substantially less than the cost of buying insurance through the Taxpayer.

Customers also buy property from the Taxpayer on credit by executing a Revolving Charge Retail Agreement ("Revolving Credit Agreement"). As part of the transaction, the Taxpayer also offers, on a separate form ("Insurance Application"), to sell customers (1) credit life and credit disability insurance and (2) credit property and casualty and credit involuntary unemployment insurance. Customers do not need to purchase this insurance. However, customers generally buy insurance from the Taxpayer.

The Taxpayer sells insurance to its customers as an agent for Insurer A, an unrelated insurance company. Insurer A is licensed to sell insurance in the state of State X. A customer buys insurance from Insurer A (1) by completing an insurance election form as part of the Rental Contract or (2) by agreeing in the Insurance Application to have his or her revolving credit account charged for the amount needed to pay premiums for the insurance. The insurance policies designate the Taxpayer as the beneficiary.

The Taxpayer receives premiums from its customers as an agent of Insurer A in accordance with an agency agreement. The Taxpayer retains 20 percent of the premiums received as a sales commission and pays 80 percent of the premiums received to Insurer A. Insurer A receives premiums and pays any claims filed during the month. Insurer A also pays state premium taxes, retains a commission, and pays reinsurance premiums to SUB, an insurance company wholly-owned by the Taxpayer. Insurer A has reinsured all of the risks arising from the sale of insurance policies to the Taxpayer's customers with SUB.

On Date Q, the Taxpayer formed SUB in Country A with a capital contribution of $BB. SUB has no employees and pays no compensation to any of its officers. SUB timely filed an election to be treated as a domestic corporation under section 953(d). SUB also filed an election to be taxed on only its taxable investment income under section 831(b). SUB's only insurance activities involve reinsuring insurance policies sold by Insurer A to the Taxpayer's customers.

SUB receives reinsurance premiums on a monthly basis from Insurer A and has a loss reserve which is re-computed on a monthly basis. The loss reserve has two segments: (1) the unearned premium reserve (one-half month of unearned premiums); and (2) the loss reserve (an estimate of how much Insurer A will pay over the life of the reinsurance contract). The loss reserve maintained by SUB is equal to approximately $AA.

SUB funds its loss reserve through an irrevocable letter of credit issued by an unrelated bank. Insurer A is the beneficiary of the letter of credit. The letter of credit was issued by the bank upon the assignment of a $AA certificate of deposit owned by SUB. The certificate of deposit is recorded on the books of SUB, not on the books of the Taxpayer.

When a loss occurs, a customer generally prepares a claim form and files the form with the Taxpayer. The Taxpayer forwards the claim form to Insurer A and Insurer A pays the Taxpayer. Once the Taxpayer has received payment, the customer is no longer obligated to pay on the Rental Contract or the Revolving Credit Agreement.

Insurer A generally pays claims from the premiums it receives from the Taxpayer. If the premiums received from the Taxpayer are insufficient to pay all claims, SUB pays Insurer A for the claim. If the Taxpayer stops using Insurer A, SUB remains liable on all policies underwritten by Insurer A that were reinsured by SUB until those policies lapse. During the tax years in issue, the amounts received by Insurer A as premiums substantially exceeded the amounts it paid for claims.

Before SUB was formed, the Taxpayer sold insurance to its customers as an agent for Insurer A. The Taxpayer received an up-front sales commission equal to forty percent of the premiums paid and paid the remainder of the premiums to Insurer A. Each quarter of the year, Insurer A returned a portion of the premiums received to the Taxpayer as retro compensation. This amount represented a portion of the net profits which Insurer A earned on insurance polices written for the Taxpayer's customers.

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 reserves maintained by SUB appear to be sufficient to support the reinsurance transaction. 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 a larger share of the profits (including investment income earned on insurance reserves) that Insurer A was earning on the insurance policies. For this to be a sufficient business purpose, the amount of profit 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 additional profit 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 electing under section 831(b) to pay tax only on its investment income. 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. Section 482

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 similar 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 owned 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 (less the up-front sales

---

[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.

commission) reduced by an administrative fee and 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 insurance companies to the finance companies 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 retro compensation, which it received before SUB was formed, 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 (40 percent) and to retro compensation, representing a share of the profits earned on those insurance policies. After the reinsurance transaction, the Taxpayer’s up-front sale commission percentage was reduced (20 percent) and its retro compensation 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 compensation) before SUB was formed. Thus, the Service may allocate income received by SUB to the Taxpayer under section 482.

C. **Section 845**

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. **Section 845(a)**

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, 98th 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 compensation 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 compensation in conjunction with a related agreement between SUB and Insurer A which effectively reallocated a portion of the sales commission and retro compensation 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 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 of a portion of the premiums is actually sales commissions earned by the Taxpayer.

We note that although SUB elected to be taxed only on its investment income under section 831(b), SUB may need to include premiums received in income when computing the amount of its alternative minimum tax liability. We also note that SUB may need to capitalize a portion of the premiums received in accordance with section 848.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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

A. 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 state law prevented the party performing the services from earning the income. [redacted]

B. Alternative Minimum Tax

A small non-life insurance company may elect to be taxed only on its investment income under section 831(b). However a small non-life insurance company must include premiums received in income when computing the amount of its alternative minimum tax liability. The Taxpayer filed a consolidated return with SUB and it appears, based on tax returns attached to the Revenue Agent's Report, to be paying alternative minimum tax for the years in issue. It is possible that the Taxpayer did not include in income the premiums received by SUB when computing its alternative minimum tax liability. Please note, after 1997, companies qualifying for the small insurance company election under section 831(b) only need to include their investment income in taxable income when computing their alternative minimum tax liability due to a statutory amendment. See sec. 56(g)(4)(B)(i).

* * * * *

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

JEFFREY L. DORFMAN