DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
1100 Commerce Street
Dallas, TX 75242

December 3, 2004

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UIL: 269.00-00; 367.01-00;
501.15-00; 953.06-00;
4371.00-00

Taxpayer Identification Number:

Legend

Form:

Taxpayers Name
Taxpayers Address

Tax Year(s) Ended:

A=Taxpayer Advocate Information

Person to Contact/ID Number:

Contact Numbers:

Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear

This is our final adverse determination letter as to your exempt status under I.R.C. § 501(c)(15) of the Internal Revenue Code. Our adverse determination was made because, for the year(s) of the examination, you were not operated as an "insurance company" within the meaning of I.R.C. § 501(c)(15) of the Internal Revenue Code. Your exempt status is revoked effective Date 4.

Our decision is outlined in the Technical Advice Memorandum that is enclosed which further explains why we believe an adjustment of your organization's exempt status is necessary.

We have also enclosed Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues, and Publication 3498, *The Examination Process.* These publications include information on your rights as a taxpayer. They explain appeal rights and the procedure for obtaining technical advice.

Appeals procedures require a minimum of 180 days remaining on the statute of limitations. In order to take advantage of appeal rights, a taxpayer might be asked to execute a consent to extend the statute of limitations to permit Appeals consideration.

Because this case involves exemption under I.R.C. § 501(c)(15), you cannot contest the adverse determination in a declaratory judgment action under I.R.C. § 7428. You can, however, contest the revocation of exempt status in the context of any related deficiency case involving adjustments that flow from the loss of exemption. Thus, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, from any deficiency notice issued in this case or a related case after satisfying procedural and jurisdictional requirements as described in Publications 3498 and 892.

You may be required to file federal income tax returns on Form 1120F for the tax period shown above, for all years still open under the statute of limitations and for all later years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

A

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

R.C. Johnson
Director, E O Examinations

Enclosures:
Publication 892
Publication 3498
Technical Advice Memorandum

No Third Party Contact.
Index (UIL) No.: 269.00-00; 367.01-00; 501.15-00; 953.06-00; 4371.00-00

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:
Taxpayer's Identification Number:

Years Involved:

No Conference Held

LEGEND:

N = "The Organization"
M = Organization's Holding Corp.
O = Bank
P = Bank Parent
Q = Trust
R = Asset
S = Lessee
U = 1st Unrelated Life Insurance Co.
V = 2nd Unrelated Life Insurance Co.
W = Unrelated Fire Insurance Co.
X = Officer of P & N
Y = Organization's State
Z = Actuary
ZX = Auditor
Date 1 = Date Policies Issued.
Date 2 = Date of Application
Date 3 = Ruling Date
Date 4 = Effective Date
Date 5 = Solicitation Date
ISSUES:

A. Whether N, a foreign corporation, which made an election under section 953(d) of the Internal Revenue Code to be treated as a domestic corporation, qualified as an insurance company for federal income tax purposes for , , or ("Years Involved").

B. Whether N continues to qualify for exemption from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(15), or should its exempt status be revoked retroactively to the date of its formation.

C. If N is not an insurance company exempt from tax pursuant to section 501(c)(15) of the Code and its election under section 953(d) is invalid then –

1. Whether M must recognize gain under section 367 of the Code on the transfer of a partnership interest to N.

2. Whether N is subject to tax under Subpart F of the Code.

3. Whether N is subject to tax under section 4371 of the Code.

D. Whether section 269 of the Code can be applied to deny P the tax benefits that accrued from the formation of N.

FACTS:

1. O is a wholly owned subsidiary of P. O is a federally regulated bank with operations in the State of Y. O owns 100% of the stock of M. O provides private and business banking services to small and middle market companies and high net worth individuals. O offers commercial and personal loans, deposit, cash management, and international banking services, and mutual fund investments. O finances automobile, credit card, small business, mortgage, and line of credit loans.

2. In addition to its banking activities, O earned income from other sources, including a 90% interest in a partnership operating as a trust called Q. Q's primary assets were Rs which Q leased to S. On its books, Q carried the Rs at salvage, all allowable depreciation having accrued[1]. Q valued the lease at $4,717,567, and it generated approximately $1.5 million of annual revenue for Q. Q was managed by a trustee. Consistent with the submission, this memorandum assumes Q is a partnership for federal tax purposes.

3. O's activities placed O in a position to offer several lines of insurance products to its customers. These included protection against a borrower's disability or financial hardship and fraud upon a depositor.

4. In 1998, P developed a business plan for entering the reinsurance market. The ostensible purpose of this plan was to allow P to profit from these lines, both as underwriter (N) and as commission sales agent (O). The plan involved establishing a company (N) in a foreign jurisdication to reinsure these risks, and, in the future, to reinsure various risks of P. In order to comply with federal banking law, O would create a wholly owned subsidiary, M, which in turn would be the sole owner of N. Though P intended to utilize sound underwriting protocols and implement an effective claims control program, because N would engage in reinsurance of coverage sold to O customers (and, in the future, of coverage provided O), it was not anticipated that N would engage in marketing activities nor would it have any employees; administrative tasks were to be outsourced. There is no discussion of N utilizing office space.

[1] The partnership agreement provided that the depreciation was allocable to O.

5. The business plan envisioned N being capitalized with approximately $5 million - $500,000 in cash/marketable securities, and $4.5 million "in an asset which generates significant annual cash flow", i.e., O's interest in Q.

6. M was incorporated under the General Corporation Law of Y as a wholly owned subsidiary of O and was organized under that state's Insurance Code.

7. To comply with federal banking law, O and the Board of Governors of the Federal Reserve System entered into an agreement allowing O to hold all of the issued stock of M. It was understood that M was to serve as an "agreement corporation" for purposes of the Federal Reserve Act to hold the shares of N, and that N's activities were to be limited to reinsuring credit risks and the risks of loss due to check fraud.

8. When it applied to the Federal Reserve for this agreement, O represented that in addition to the par value capital, N "will receive an asset of [O] with a fair market value of approximately $4.5 million. The purpose of transferring this asset is to provide [N] with adequate capital for both current and future business. The application also states that Z, Ltd. and ZX had been engaged as consulting actuary and public auditor, respectively.

9. N was established on Date 1, under the laws of a foreign jurisdiction. N's Memorandum of Association indicates that its objects and powers include "the business of insurance, captive insurance, and reinsurance, to act as agents and/or brokers for insurance companies and syndicates, to accept risks, settle claims, [illegible] insurance business and all other matters incidental thereto." N was authorized to issue 500,000 shares with a par value of $1.00 for total initial capitalization of $500,000. N was capitalized as described in Facts 5 and 8[2].

10. N elected under section 953(d) of the Code to be treated as a domestic corporation.

11. O entered into an Agency Agreement dated December 1, 1998, with U Life Insurance Company, an unrelated company. The agreement appointed O an agent of U to solicit applications for credit life and credit disability insurance from O's mortgage debtors under the terms of coverage set out by U.

12. On February 2, 1999, O applied to U for a group credit policy covering O's debtors effective December 1, 1998.

13. At some point, U ceded to V the credit life and disability risks U assumed under the policies O sold as its agent. V is unrelated to P.

14. In 1998, V retroceded the credit life and disability risks to N. This agreement was augmented by a Reinsurance Trust Agreement, whereby a trust account was opened for the sole use and benefit of V. This account was to contain investments in

[2] We offer no opinion on the tax consequences of, or the tax attributes arising from, this capitalization.

obligations of the United States, certificates of deposit, or high-grade corporate debt instruments, in an amount equal to 100% of the reserves in accordance with the retrocession agreement.

15. In 1998, P solicited seven officer/employees of O who were also mortgagors to purchase credit disability coverage offered by U. Of the seven, five accepted. U issued credit disability policies to the five officer/employees at the end of Date5, effective for one year, for an aggregate direct premium of $2,054.84. These policies provided that in the event the policyholder became totally disabled for more than 30 days (subject to exclusions), U would pay a stated amount per month until "elimination" (e.g., the policy expires or the loan is satisfied). The benefit amount was determined by reference to the policyholder's monthly loan payment: the benefit amount was set at the greater of the loan payment or $1,000. It is unknown whether any of these officer/employee policyholders filed a claim for benefits or U's experience with respect to similar policies.

16. These internal memoranda were the extent of O's solicitation efforts as agent for U. The risks covered provided by these policies were, pursuant to the operative reinsurance and retrocession agreements, ultimately assumed by N. This block of five policies comprise the extent of N's assumed risk during 1998. N's premium was the aggregate direct premium of $2,054.84, less O's agent commission, the reinsurance and retrocession commissions, and any administrative fees.

17. On Date 2, N filed an Application for Recognition of Exemption Under Section 501(a), Form 1024, asking to be recognized as an organization described in section 501(c)(15) of the Code. On this Application, N indicated that it would possess a "lease receivable", i.e., O's interest in Q, worth $4,714,567. Despite the anticipation that the lease would "generate significant annual cash flow", the revenue from this asset was not included in the income projections provided on the Application. At the time of this Application, the retrocession agreement from V was still N's only insurance activity.

18. On Date 3, the Service issued N a letter recognizing that as of Date 4, N was an organization described by section 501(c)(15) of the Code hence exempt from tax under section 501(a).

19. At some point during 1999, two of the officer/employee policyholders cancelled their policies. Of the remaining three policies in force at their expiration, only one renewed.

20. On Date5, O solicited five customers to obtain credit disability coverage offered by U free of premium. None accepted. This was the extent of O's solicitation efforts as agent for U during Year.

21. As of the end of 1999, the only U policy sold by O as agent that was still in force was the renewed policy issued to an officer/employee of O. (N's assumed risk during 1999 initially consisted of the five policies issued to the officer/employee of O, of which two were canceled and two were allowed to lapse.)

22. During 2000, O did not solicit the sale of additional credit risk policies as agent for U, nor were additional U credit policies solicited.

23. W issued to O "and depositors of record for Checking, NOW, and Money Market accounts" a policy covering "loss due to forged, stolen or counterfeit checks" of O's depositors, "provided such loss is due to forged, stolen or counterfeit checks" drawn on O accounts during the policy period of October 1, 2000 to October 1, 2001 ("Check Fraud Policy"). The Check Fraud Policy had a deductible of $25,000 per event; that is, O retained liability for the first $25,000 of loss. The coverage limit of the Check Fraud Policy was $1,200,000. The premium paid by O upon application for the Check Fraud Policy was $227,204.00. During the covered period, O suffered a covered loss – over its deductible – of $26,450 which N paid. However, it appears that of this amount $10,000 was paid during 2000.

24. W is not related to P, O, M, or N.

25. By letter dated October 1, 2000 from N to W, N agreed "to assume 100 percent of the losses from the [Check Fraud Policy]"; "[t]here is no ceding premium."

26. In 2000, N entered into a management agreement with Z whereby for a fee Z agreed to manage N's operations, including providing necessary personnel, handling correspondence, and maintaining necessary records. However, Z was not authorized to take any action regarding the insurance business, such as resolving claims or making any commitments without the agreement of N.

27. The only known meeting of N's board of directors occurred on October 26, 2000 and lasted four minutes. The minutes reflect that the topics discussed were the results of N's operations through September 30, 2000 and the "status of efforts to sell the R's under lease to S and owned by [N][3]".

28. N did not have a staff. However, X, an officer of both P and N, indicates that during some or all of the years involved he spent as much as 20% of his working time on N matters. X was not compensated by N for such work.

29. N filed Returns of Organization Exempt from Income Tax, Form 990, for the Years Involved. On its Form 990 (covering the period of to), N reported program service revenue (i.e., premiums) of $8. N reported no expenses incurred.

30. Part IV of the Form 990, the balance sheet, reflected its initial capitalization of $500,000, the contribution of O's interest in Q ("lease receivable") of $4,714,567, and "accounts receivable" which apparently was the total premiums collected with regard to

[3] This may be a misstatement. It appears that the Rs were owned by Q. Nothing in the submission reflects a transfer of the Rs to N. However, given that N's partnership interest was 90%, for all practical purposes N was the owner.

the retrocession of the five credit policies issued to its officer/employees, $1,602. As liabilities, N reported "loss reserves" of $1,594, which appear to be unearned premiums ($1,594 = "accounts receivable" $1,602 – "program revenue" $8). N's net assets were $5,214,657.

31. On its Return, N reported total revenue of $1,688,606 comprised of program service revenue of $53,439 (described in Part VII as "reinsurance premium"), income from securities held of $920, and income from "lease receivable" (i.e., Q) of $1,634,247[4]. Expenses of $15,497 were reported, comprised of $5,459 for "program services" (described in Part II as "licensing fees") and $10,038 for management and general expenses[5]. The result was net earnings of $1,673,109.

32. On Part IV of its Return, N reported "other liabilities" of $15,497. These liabilities were comprised of a note payable of $15,000 and "unearned premiums" of $314. Loss reserves were reported as $"0". N reported net assets of $6,818,866.

33. On its Return, N reported total revenue of $1,727,427, comprised of $55,577 in "program service revenue" (described in Part VII as "reinsurance premiums"), $62,680 in income from securities held, and $1,609,170 from "lease receivable"[6]. N reported expenses of $29,016, comprised of $10,000 for "program services" (described in Part II as "claims expense") and $19,016 for management and general expenses (described in Part II as a management fee of $10,000 and a license fee of $9,016).

34. On Part IV of its Form 990, N reported "other liabilities" of $179,945. These liabilities were comprised of accrued professional fees of $3,000, "unearned premiums" of $166,945, and a loss reserve of $10,000. N's net assets were $8,506,712.

LAW and ANALYSIS

<u>A. Whether N, a foreign corporation, which made an election under section 953(d) of the Code to be treated as a domestic corporation, qualified as an insurance company for federal income tax purposes for the Years Involved.</u>

The business of an insurance company necessarily includes substantial investment activities. Both life and nonlife insurance companies routinely invest their capital and the amounts they receive as premiums. The investment earnings are then used to pay claims, support writing more business or to fund distributions to the company's owners. The presence of investment earnings does not, in itself, suggest that an entity does not qualify as an insurance company.

For the years involved, an insurance company for federal income tax purposes is

[4] The Form 990 is confusing on this. Part IV-A, book-tax reconciliation, reflects that Q produced $1,487,296 of revenue instead of the $1,634,347 reported under Part I.
[5] Given that X indicated that he was not compensated by N for his work on its behalf, and that the agreement with Z was not reached until , we are not sure what this expense was for.
[6] There is a discrepancy in N's Form 990 similar to that described at note 8.

a company whose primary and predominant business activity during the year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 1.801-3(a)(1) of the Income Tax Regulations; section 816(a) of the Code (company treated as an insurance company for purposes of definition of a life insurance company only if more than half of the business of that company is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies).

Neither the Code nor the regulations define the terms insurance or insurance contract. The United States Supreme Court, however, has explained that for an arrangement to constitute insurance for Federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941). The risk shifted and distributed must be an insurance risk. See, e.g., Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978); Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

Section 1.801-3(a) of the regulations defines the term "insurance company" to mean a company whose primary and predominant business activity during the taxable year is the issuance of insurance or annuity contracts or the reinsurance of insurance underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code. See also Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972) (taxpayer whose predominant source of income was from investments did not qualify as an insurance company); Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932). To qualify as an insurance company, a taxpayer must use its capital and efforts primarily in earning income from the issuance of contracts of insurance. Indus. Life Ins. Co. v. United States, 344 F. Supp. 870, 877 (D. S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973). All of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether the company engages in other trades or businesses, and its sources of income. See generally United States v. Home Title Ins. Co., 285 U.S. 191, 195 (1932) (where insurance and charges incident thereto were more than 75% of company's income, "[u]ndeniably insurance

[was] its principal business."); Lawyers Mortgage Co. at 188-90; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 425 F. 2d 1328 (5th Cir. 1970); Serv. Life Ins. Co. v. United States, 189 F. Supp. 282, 285-86 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-American Life Ins. Co., at 506-08 ; Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933). However, a company engaged solely in reinsurance may have a very sparse operation. See Alinco Life Ins. Co. v. United States, 178 Ct. Cl. 813, 837-38 (1967)(that reinsurance company had extremely simple operation with very little general operating expense did not preclude conclusion that it was a life insurance company under section 801 of the Code).

In Lawyers Mortgage Co., supra, the Court concluded the taxpayer was not an insurance company based on the character of the business actually done. The taxpayer was chartered as "Lawyers Mortgage Insurance Co." to examine titles and to guarantee or insure bonds and mortgages. Later, the company dropped "insurance" from its name and amended its charter to allow the purchase and sale of mortgage loans. It remained under the supervision of the state insurance department. However, Lawyers Mortgage never insured titles. Rather, it made mortgage loans which it sold with a guarantee of payment. For this "insurance", Lawyers Mortgage charged a "premium" of one-half of one percent of the interest stated on the mortgage. The company also guaranteed the payment of some loans which it did not make or sell. Under state law, companies chartered as banks were also authorized to conduct this type of business. The Court concluded that though the guarantees were in legal effect insurance, this element of Lawyers Mortgage's activities was only incidental to the mortgage business; the "premium" covered non-insurance services. And the "premiums" were only one-third of Lawyers Mortgage's income. The character of the business actually done was not insurance, therefore, the company was not an insurance company.

Similarly, in Industrial Life Ins. Co., supra, the taxpayer was not an insurance company for federal income tax purposes because it was not using its capital and efforts primarily to earn income from insurance. Industrial Life was chartered as an insurance company but did not maintain a sales staff. Its office was located in the home of its president. During the three years at issue, the company's insurance activity consisted of covering small credit risks under a group policy issued to a consumer lender, covering the lives of certain of its officers (the company paid the premiums and was the beneficiary), and covering the lives of members of the stockholding family. The company also engaged in leasing and selling real estate and managing its investment portfolio. Industrial Life's premium income from insurance issued to parties unrelated to its owners/officers (i.e., the group credit risk policy) accounted for approximately 8% of its income during the years at issue. The company accumulated substantial earnings without showing a reasonable need. The district court concluded that Industrial Life was not an insurance company during the years at issue. Although it was involved in direct underwriting, it issued only one policy and its premium income was small compared with its income from its real estate activity.

Cardinal Life Insurance Co., supra, involved a company chartered to write life, health and accident coverage. During two of the five years at issue, Cardinal Life did not issue insurance contracts or reinsure risks underwritten by insurance companies; its premium income was $0 and it had no reserves. For the remaining three years, Cardinal Life reinsured risks underwritten by an insurance company; its premium income was less than 1% of its income for two of those years and approximately 9% in the third. Its reserves were minimal. Cardinal Life never employed any agents or brokers though it did retain an actuary; the reinsurance agreement was negotiated by its one stockholder. Meanwhile, Cardinal Life had income from dividends and interest, leasing real estate and trailers, and capital gains. The district court concluded that Cardinal Life was not an insurance company because its capital and efforts were devoted primarily to its investment activity; it did not solicit insurance business and derived insignificant amounts of income from what insurance business it transacted while deriving substantial income from its investments.

Inter-American Life Ins. Co., supra, likewise involved a taxpayer that did not qualify as an insurance company due to its minimal volume of insurance business. Two individuals formed Investment Life Insurance Company to directly underwrite coverage which could be ceded to Inter-American. Although Inter-American was authorized to use several policy forms, it did not solicit or sell any directly written coverage during the years at issue. Rather, it accepted a small amount of business ceded to it by Investment Life and an unrelated insurer. Inter-American also held the family's lumber business as loaned surplus. Because of its minimal insurance activity, the state insurance commissioner became concerned about its continued participation in the insurance market. As a result, rather than surrender its certificate of authority to write insurance, Inter-American retroceded a major portion of its coverage to an unrelated company. Meanwhile, Inter-American realized income from various capital assets. Although Inter-American had as many as 448 policies in force during the five years at issue with an aggregate coverage of $1.4 million, premiums accounted for 5% or less of Inter-American's income during four of the five years. The court concluded that Inter-American was not an insurance company for any of the years at issue because it did not use its efforts in the insurance business. It did not actively solicit to issue coverage. Its directly underwritten coverage was issued to the owner's family or their tax advisor and its reinsurance was from the related company, Investment Life. Its investment income far exceeded its de minimis earned premiums.

In contrast, the taxpayer in Service Life Ins. Co., supra, was held to be an insurance company under different facts. During the years at issue, Service Life issued life, health and accident policies, and also solicited and arranged mortgage loans with money borrowed from the Federal Home Loan Bank. Between 35,000 and 70,000 policies were in force during the years at issue, representing life coverage of over $22,000,000. At the same time, only about 1,800 mortgages were outstanding. Service Life's premium income accounted for between 57% and 79% of its total income. Under these facts, the character of the business actually done by Service Life during the years at issue was insurance; hence it was an insurance company.

No single factor determines whether a company's primary and predominant business activity for a taxable year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, in some cases, a start-up company (or a company winding down operations) may qualify as an insurance company even if premiums represent less than half the receipts of the company provided the company's capital and efforts is devoted primarily to its insurance business.

1.

In , U, a commercial insurer, issued credit liability policies to five employees of O. Although we received no representations to this effect, we assume U issued a sufficient number of other, unrelated contracts in that those issued to O employees qualified as insurance contracts in their own right[7]. Risks under those contracts were reinsured with V, and retroceded to N.

Both risk shifting and risk distribution are prerequisite to concluding an arrangement qualifies as an insurance contract for federal income tax purposes. In particular, risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. As noted above, risk distribution also entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. Even if the contracts issued by U qualified as insurance contracts by virtue of that company's other business, it is necessary to consider whether the risks ceded to V and retroceded to N represented a sufficient number of insureds to qualify as a block of insurance business as to N. The fact that a fronting company itself qualifies as an insurance company does not eliminate the need for risk distribution as to the entity that ultimately assumes the underlying risks. Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 410-11 (3rd Cir. 1990); Kidde Indus. Inc. v. United States, 40 Fed. Cl. 42, 56 (1997)(finding risk distribution where subsidiary reinsures risks of sister corporations), appeal dismissed, 194 F.3d 1330 (Fed. Cir. 1999). In the present case, the block of business assumed from V represented the credit disability risks of only five individuals. These are too few "insureds" for the risks assumed by N to constitute reinsuring of risks underwritten by an insurance company. Even if the retrocession of the contracts issued to the five employees constituted reinsuring risks underwritten by an insurance company, N was an insurance company for federal income tax purposes during 1998 only if this was its primary and predominant business activity.

N's tax year lasted 21 days. During this time, it was established, capitalized, licensed, and entered into the retrocession agreement with V representing five "insured" employees of O. It acquired total assets worth $5 million, including the Q interest in leased property of $4.5 million. Its retrocession agreement with V resulted in earned premiums of $8 and loss reserves (or, more likely, unearned

[7] Although not represented by the parties to the request for technical advice, A.M. Best indicates that U had more than $38 million direct written premiums, and rated the company A+.

premiums) of $1,594. There is no evidence that N's capital and efforts were devoted primarily to the "insurance" business. N's assumed coverage depended upon the efforts of O to sell policies; O's only effort was to solicit seven of its employees. N made no effort to solicit other insurance or reinsurance business. N's capital was substantially disproportionate to the risks undertaken. The premium income and "loss reserves" were insignificant compared to the value of the Q interest.

Under the facts presented, we cannot conclude that N was an insurance company for federal income tax purposes during 1998.

2.

During , two of the five credit disability policyholders cancelled their policies. Of the remaining three policies in force at their expiration, only one renewed. On Date 5, O solicited five customers to obtain credit disability coverage through U free of premium. None accepted. No other efforts were made by O to secure additional policyholders. Thus, at the end of , only a single policyholder remained by reason of the retrocession by V to N. Clearly, this did not satisfy the requirement of risk distribution; thus, the retrocession of this policy did not constitute the business of insurance as to N.

Even if N's retrocession of the one policy from V constituted the business of insurance, this activity was dwarfed by N's investment activity. N reported premium revenue of $920, unearned premiums of $314, and no loss reserves. Its income from securities was $553,439 and from Q $1,634,247. N's premium income was 0.05% of its total income. Inasmuch as its reported loss reserves were $0, its capital was disproportionately large compared to its assumed risk. Moreover, despite the dearth of insurance activity, during N made no other effort to issue insurance contracts or reinsure risks underwritten by an insurance company.

For , N did not qualify as an insurance company for federal income tax purposes.

3.

For the year , N's only "insurance" activity consisted of the risks it assumed from W with respect to the Check Fraud Policy (and, possibly, a single credit disability policy issued in and retroceded from V). The Check Fraud Policy indemnified both O and a large number of depositors in the event of forged, stolen, or counterfeit checks. We were not provided sufficient information concerning the Check Fraud Policy to determine whether N's reinsurance of that contract could involve sufficient risk shifting and risk distribution to qualify as an insurance arrangement for federal income tax purposes. For example, if the coverage was primarily of risks of O, the arrangement would be akin to that in Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981); see also Rev. Rul. 2002-89, 2002-2 C.B. 984, and could not by itself qualify as an insurance activity for federal income tax purposes. The fact that N paid a claim(s) totaling $26,450 during the covered period does not alter the characterization of the arrangement. On the other hand, if the coverage extended sufficiently to risks of the depositors, the fact that O was also insured may not necessarily prevent insurance characterization. See, e.g., Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135 (Fed Cir. 1993).

Even if N's coverage of the Check Fraud Policy qualified as an insurance activity, N's efforts in connection with that activity were dwarfed by its investment activities, in particular Q interest. For , N's putative insurance premiums of $55,577 accounted for less than 4% of its total revenue of $1,727,427, and its loss reserves of $10,000 represented less than 1% of its total assets. Over 95% of its revenue was derived from securities and the Q Partnership interest. It contracted management tasks to Z, but significantly those tasks did not include insurance-related tasks such as resolving claims or making commitments with respect to the "insurance" operations. The only reported board of directors meeting during lasted four minutes; the minutes of the meeting reflects that the only discussion of prospective activities concerned the Q interest.

There is no evidence that N made any effort to market insurance or reinsurance other than the retrocession from V and the reinsurance from W. It is clear that N did not use its capital and efforts primarily in earning income from issuing insurance contracts or reinsuring risks underwritten by insurance companies.

For , N did not qualify as an insurance company for federal income tax purposes.

B. Whether N continues to qualify for exemption from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(15), or should its exempt status be revoked retroactively to the date of its formation.

Under section 501(a) of the Code, organizations described in subsection 501(c) are exempt from federal income tax unless such exemption is denied under section 502 or 503.

For tax years beginning before January 1, 2004, section 501(c)(15)(A) of the Code provided an exemption from federal income tax for insurance companies or associations other than life (including interinsurers and reciprocal underwriters) if the net written premiums (or, if greater, direct written premiums) for the taxable year did not exceed $350,000.

Section 501(c)(15)(B) of the Code provided that when an entity was part of a controlled group, all net written premiums (or direct written premiums) or net written premiums of the members of the group were aggregated to determine whether the insurance company met the requirements of section 501(c)(14)(A).

Neither section 501(c)(15) of the Code nor the regulations under that section define an "insurance company." Accordingly, the term "insurance company" has the same meaning under section 501(c)(15) as it does in Subchapter L. See H. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess. (Vol.II) 370-71, reprinted in 1986-3 (Vol.4) C.B. 370-71.

As discussed above, were N a domestic corporation, it would not have qualified as an insurance company (other than life) under part II of subchapter L of the Code for the year involved, and therefore was ineligible to make the election under section 953(d). Because N was not an insurance company, N did not qualify for recognition of exemption from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(15) during the Years Involved and its exemption should be revoked.

N has not requested relief under section 7805(b) of the Code.

C(1). Whether M must recognize gain under section 367 of the Code on the transfer of a partnership interest to N.

Section 367(a)(1) of the Code generally provides that if a U.S. person transfers property to a foreign corporation in an exchange described in section 351, for purposes of determining the extent to which gain shall be recognized, such corporation shall not be considered to be a corporation.

Section 367(a)(3) of the Code provides an exception to the recognition of gain if the property was transferred for use by the foreign corporation in the active conduct of a trade or business outside the United States. Section 1.367(a)-2T of the regulations further discusses the requirements of the active trade or business exception.

Section 367(a)(4) of the Code generally provides that a transfer of a partnership interest shall be treated as a transfer of the transferor's pro rata share of the partnership's assets. See also section 1.367(a)-1T(c)(3)(ii)(A) of the regulations. That is, the applicability of the active trade or business exception is made with reference to the property owned by the partnership, rather than the partnership interest itself.

Section 367(a)(3)(B) of the Code generally provides that to the extent relevant and, except as provided in regulations, the active trade or business exception of section 367(a)(3)(A) shall not apply to leased property with respect to which the transferor is the lessor at the time of the transfer, if the property was leased to a person other than the transferee. However, see section 1.367(a)-4T(c)(1) of the regulations, discussed below.

Section 1.367(a)-4T(b)(1) of the regulations states that if U.S. depreciated property is transferred to a foreign corporation in an exchange described in section 367(a)(1), the transferor must include in its gross income in the year in which the transfer occurs, ordinary income equal to the amount the transferor would have been required to include in gross income under section 1245(a) had it sold the property at its fair market value. This recapture of depreciation is required regardless of whether the active trade or business exception is applicable. U.S. depreciated property is defined in section 1.367(a)-4T(b)(2) to include any section 1245(a) of the Code property (as defined in section 1245(a)(3)) which has been used in the United States prior to its transfer.

Section 367(a)-4T(c)(1) of the regulations discusses the requirements of the active trade or business exception as it relates to leased tangible property. To come within the exception, the lessee must not be expected to, and must not actually use the property in the United States. In addition, the transferee corporation's lease of the property must constitute the active conduct of a leasing business, and the transferee must have a need for substantial investment in assets of the type transferred. The active conduct of a leasing business requires that the employees of the transferee perform substantial marketing, customer service, repair and maintenance, and other substantial operational activities with respect to the transferred property outside the United States.

Section 1.367(a)-1T(b)(4) of the regulations states that if a U.S. person is required to recognize gain under section 367 of the Code upon a transfer of property to a foreign corporation, then the character and source of such gain shall be determined as if the property had been disposed of in a taxable exchange with the transferee foreign corporation.

Section 1.367(a)-1T(c)(3)(ii)(B) of the regulations states that if a U.S. person is treated as having transferred a proportionate share of the property of a partnership in an exchange described in section 367(a) of the Code, and is therefore required to recognize gain upon the transfer, then

> (1) the U.S. person's basis in the stock of the transferee foreign corporation shall be increased by the amount of the gain so recognized by that person,
> (2) the transferee foreign corporation's basis in the transferred partnership interest shall be increased by the amount of the gain so recognized by that person, and
> (3) solely for purposes of determining the partnership's basis in the property held by it, the U.S. person shall be treated as having acquired an interest in the partnership permitting the partnership to make an optional adjustment to basis pursuant to sections 743 and 754.

Under section 367(a)(1) of the Code, M is generally required to recognize gain on the transfer of the partnership interest to N, unless the active trade or business exception applies. For purposes of section 367(a) M is treated as transferring a 90% interest in the underlying assets of the partnership. Relevant here, is the partnership's lease of the Rs that were used and depreciated for tax purposes in the United States. Based upon the foregoing, it is the Rs, rather than the partnership interest which is considered as transferred for purposes of section 367(a). See section 367(a)(4); and section 1.367(a)-1T(c)(3)(ii)(A) of the regulations.

The Rs are property described in section 1245 of the Code.[8] Further, we assume the Rs were used in the United States while the Rs were subject to depreciation prior to the transfer of the partnership interest to M. Accordingly, regardless of whether the active trade or business exception might otherwise apply, under section 1.367(a)-4T(b) of the regulations, M would be required to recapture as ordinary income the amount that O had previously depreciated the Rs. The recaptured amount will not exceed the realized gain on the transfer.[9]

To the extent the realized gain on the transfer exceeds the amount to be recaptured, the gain may be potentially deferred under the active trade or business exception, provided that exception otherwise applies. See section 1.367(a)-4T(b)(1) of the regulations. However, we conclude that the active trade or business exception would not apply to defer M's gain in excess of the depreciation recapture amount. First, it appears from the submission that at the time of the transfer of the partnership interest to N, the lessee, Q, was expected to, and did continue to use the Rs in the United States. Second, even if the Rs were not used in the United States, neither N nor the partnership were engaged in the active conduct of a leasing business outside the United States as contemplated by section 1.367(a)-4T(c). N had no employees, except for its officers; to the extent that the lease had to be managed, it was managed by the partnership. In addition, since the lease was a triple net lease, it is clear that the partnership or its employees did not perform the substantial operational activities envisioned by section 1.367(a)-4T(c). Accordingly, M will not come within the active trade or business exception for leased property for the realized gain in excess of the amount recaptured for depreciation.

Based on the foregoing analysis, all of the gain inherent in N's pro rata share of the partnership's assets (the Rs) will be included in N's gross income.

M must recognize gain on the transfer of the partnership interest to N. In determining the gain which M must recognize, the amount realized is the fair market value of M's 90% indirect interest in the Rs, and M's basis is the amount of its basis in the partnership interest which is attributable to its interest in the Rs. The gain will be characterized as ordinary income to the extent depreciation deducted by O must be recaptured under section 1.367(a)-4T(b) of the Regulations. The remaining gain will be characterized in the same manner as if M had disposed of the Rs in a taxable exchange with N. See section 1.367(a)-1T(b)(4).

In addition, under section 1.367(a)-1T(c)(3)(ii)(B) of the regulations, M will

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[8] However, there is no indication in the record as to whether the section 1245 property is property described in section 704(c). Rather, the submission assumes that gain from a sale of the property would be allocated equally between the two partners and would not be subject to section 704(c). The facts should be developed on these matters. However, for purposes of our discussion, we assume the property is not section 704(c) property of M, and that the gain would be allocated based upon the partner's respective ownership interests.

[9] If, in fact, the Rs had been used both within and without the United States during the period in which the Rs were subject to depreciation by M, or a party related to M, e.g., O, only a ratable portion of the depreciation would have to be recaptured. See section 1.367(a)-4T(3) of the regulations.

increase its basis in the stock of N to reflect the gain it must recognize, and N will increase its basis in its partnership interest in the amount of the gain M recognized. The partnership may make an optional adjustment to basis pursuant to sections 743 and 754 to reflect the gain M must recognize.

C(2). Whether N is subject to tax under Subpart F of the Code.

Section 953(d) of the Code allows a foreign insurance company to elect to be treated as a domestic company for tax purposes if it meets certain requirements. One such requirement is that the foreign company must be a company that would qualify under part I or II of subchapter L for the taxable year if it were a domestic corporation.[10]

If it is determined that a controlled foreign corporation ("CFC") does not qualify as an insurance company under part I or part II of subchapter L, it will fail to meet the requirements for electing under section 953(d)(1) to be treated as a domestic corporation. Therefore, it will be treated as a foreign corporation for tax purposes. As a foreign corporation with U.S. shareholders, it will potentially be subject to the subpart F, passive foreign investment company ("PFIC"), and foreign personal holding company ("FPHC") regimes.

A. Subpart F

The subpart F regime applies to foreign corporations that qualify as CFCs.[11] Section 957 of the Code defines a CFC as a foreign corporation with regard to which more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned by U.S. shareholders. A U.S. shareholder, in turn, is defined under section 951(b) as a U.S. person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.

Therefore, a corporation with regard to which more than 50% of the vote or value is owned by U.S. persons who individually own 10% or more of the vote will qualify as a CFC under section 957 of the Code. As a CFC, its U.S. shareholders must include in gross income their pro rata shares of the corporation's subpart F income, as defined in section 952, and the amounts determined under section 956, which are based on the U.S. property held by the CFC.

1. Subpart F Income

Section 951(a)(1)(A)(i) of the Code requires a U.S. shareholder of a CFC to include in gross income such shareholder's pro rata share of the CFC's subpart F income for the year. Section 952(a) defines subpart F income to include, among other things, insurance income, as defined in section 953, and foreign base company income, as defined in section 954.

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[10] See section 953(d)(1)(B).
[11] *See* secion 951(a)(1).

a. Insurance Income

Section 953(a)(1) of the Code defines insurance income to mean income which (A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and (B) would be taxed under subchapter L if such income were the income of a domestic insurance company. Therefore any premium income received by a CFC could qualify as insurance income for purposes of 953 even though the CFC fails to qualify as an insurance company under subchapter L. Furthermore, any income generated from investment of the premium income will also be subpart F insurance income because insurance income is defined broadly, under section 953(a)(1), as "any income which is attributable to the issuing (or reinsuring) of an insurance or annuity contract."

Section 953(a)(2) of the Code excepts "exempt insurance income (as defined in subsection (e)" from the definition of insurance income. However, to qualify as exempt insurance income, such income must be derived by a qualifying insurance company. See section 953(e)(1)(A). A qualifying insurance company is defined as a company that "is engaged in an insurance business and would be subject to tax under subchapter L if it were a domestic corporation." See section 953(e)(3)(C). If it is determined that a CFC does not qualify as an insurance company under subchapter L, it will not meet the definition of a qualifying insurance company for purposes of section 953(e). Therefore none of its insurance income will be exempt insurance income.

b. Foreign Personal Holding Company Income

Section 954(a)(1) of the Code defines foreign base company income to include foreign personal holding company income ("FPHCI"). FPHCI is defined under section 954(c)(1) to include dividends, interest, royalties, rents, and annuities as well as gains from certain types of transactions and certain interest or dividend equivalents. To the extent a CFC has any of these passive types of income that are not otherwise picked up under section 953, this income may be FPHCI under section 954(c).

2. Section 956 Income

Section 951(a)(1)(B) of the Code requires a U.S. shareholder of a CFC to include in income its pro rata share of the amount determined under section 956 with respect to such shareholder for the year to the extent such income is not excluded under section 959(a)(2) (pertaining to earnings and profits attributable to section 956 amounts previously included under section 951(a)(1)(B)).

The section 956 amount, with respect to a U.S. shareholder, is the lesser of (1) such shareholder's pro rata share of the average amount of U.S. property held by the CFC as of the close of each quarter of the taxable year less the amount of earnings and profits attributable to section 956 amounts previously included in gross income under section 951(a)(1)(B), or (2) such shareholder's pro rata share of the applicable earnings of the CFC.[12] Applicable earnings, in turn, is defined under section 956(b)(1) as the sum of the amount of current and accumulated earnings and profits, as defined in section 316(a)(1) and (2), reduced by distributions made during the taxable year and by earnings and profits described in section 959(c)(1) (earnings and profits attributable to amounts previously taxed under section 951(a)).

For purposes of section 956 of the Code, U.S. property includes obligations of U.S persons and tangible property located in the U.S.[13] Section 956(c)(2) provides a number of exceptions to the definition of U.S. property, including section 956(c)(2)(F), which excepts from U.S. property the obligations of a domestic corporation which is neither a U.S. shareholder of the CFC nor a domestic corporation 25% or more of the total combined voting power of which is owned by U.S. shareholders of the CFC.

B. PFIC

Pursuant to section 1297(a) of the Code, a foreign corporation is a PFIC if, during the taxable year (1) 75% or more of its gross income is passive income, or (2) at least 50% of the average percentage of assets held by the foreign corporation are assets that produce passive income or are held for the production of passive income. Section 1297(b), with certain exceptions not relevant here, defines passive income to mean any income that would be foreign personal holding company income as defined in section 954(c) (i.e. dividends, interest, royalties, rents, annuities, and gains from the sale or exchange of property giving rise to certain types of income).

Section 1297(b)(2)(B) of the Code excludes from the definition of passive income any income derived in the active conduct of an insurance business by a corporation predominantly engaged in an insurance business which would be subject to tax under subchapter L if it were a domestic corporation.

Section 1297(e) of the Code provides that a foreign corporation shall not be treated as a PFIC with regard to a shareholder for periods after December 31, 1997, during which the shareholder is a U.S. shareholder and the foreign corporation is a CFC. However, section 1298(b)(1) states that stock will be treated as stock in a PFIC if at any time in the shareholder's holding period of the stock, the corporation was a PFIC and no purging election was made under section 1298(b)(1) with respect to such stock. Therefore, if a CFC qualified as a PFIC prior to 1998 it would continue to be a PFIC today if no purging or QEF election was ever made for the corporation.

A CFC that qualifies as a PFIC will be subject to the section 1291 regime. Section 1291 imposes an increase in tax and interest charges on U.S. persons that receive "excess distributions," as defined in section 1291(b), in respect of stock in a PFIC. An actual distribution is an excess distribution only to the extent the actual distributions received by a shareholder exceed 125% of the average amount of

[12] Section 956(a).
[13] Section 953(c)(1)(A), (C).

distributions received by the shareholder in the three preceding taxable years.[14] Gain recognized on the disposition of PFIC stock is also treated as an excess distribution. *See* section 1291(a)(2).

C. FPHCI

A foreign corporation is a FPHC if it meets both a gross income test and a stock ownership test as set out in section 551(a) of the Code. The gross income test is met if 60% or more (or 50% or more in subsequent years once FPHC status is established) of the foreign corporation's gross income is FPHCI as defined in section 553 (i.e. dividends, interest, royalties, annuities, net stock or security gains, etc.).[15] The stock ownership test is met if more than 50% of the value or total combined voting power of all classes of stock is owned by five or fewer individuals who are U.S. citizens or residents.[16] However, section 951(d) provides that if income would be included both under section 951(a)(1)(A)(i) (subpart F income) and under section 551(b) (foreign personal holding company income), then such amount shall be included in the gross income of the shareholder only under section 951(a)(1)(A)(i).

In summary, if a section 953(d) election made by a CFC is determined to be invalid, the CFC will be treated as a foreign corporation. Because it is a CFC, the subpart F regime will apply. In addition, the CFC may be a PFIC. In that case, the section 1291 regime will apply as well. Although the CFC will also qualify as a FPHC, there will be no FPHC tax consequences because where both the FPHC rules and the subpart F rules apply, subpart F takes priority.

C(3). If N is not an insurance company and its section 953(d) election is invalidated, whether N is subject to the section 4371 excise tax

Section 4371 of the Code imposes a tax on each policy of insurance, indemnity bond, annuity contract or policy of reinsurance issued by any foreign insurer or reinsurer. Section 4372(a) defines "foreign insurer" as an insurer who is a nonresident alien individual, or a foreign partnership, or a foreign corporation. Section 4371(1) imposes the tax at a rate of four cents on each dollar, or fractional part thereof, of the premium paid on a policy of casualty insurance or indemnity bond, if issued to or for, or in the name of an insured as defined in section 4372(d). Section 4372(d) defines the term "insured" to mean "a domestic corporation or partnership, or an individual resident of the United States, against, or with respect to, hazards, risks, losses, or liabilities wholly or partly within the United States" or "a foreign corporation, foreign partnership, or nonresident individual, engaged in a trade or business within the United States, against, or with respect to, hazards, risks, losses, or liabilities within the United States".

Under the doctrine of Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), federal income tax law usually regards a foreign subsidiary, whether or not

[14] *See* section 1291(b).
[15] Section 551(a)(1).
[16] Section 551(a)(2).

controlled by U.S. persons, *as a foreign taxpayer* that is legally distinct from its shareholders. See sections 1.11-1(a) and 1.881-1 of the regulations. A foreign subsidiary of a domestic corporation, therefore, may fall within the definition of "foreign insurer" set forth in section 4372(a). Because a foreign subsidiary may be considered a "foreign insurer" for purposes of section 4371 of the Code, premiums paid to a foreign subsidiary may be subject to the excise tax if the foreign subsidiary issues an insurance policy, as an insurer or reinsurer, to or for, or in the name of an "insured" as defined in section 4372(d). See section 4371(1).

Thus, if N is not an insurance company and its section 953(d) election is invalid, and N is an insurer or reinsurer and is therefore a "foreign insurer" as defined by section 4372(a) of the Code, it will be subject to the tax imposed by section 4371 if it issued policies of insurance or reinsurance to an "insured" as defined by section 4372(d). However, the facts provided are insufficient for us to determine whether the contracts retroceded to N by V as well as the check fraud contracts are insurance policies.

D. Whether section 269 of the Code can be applied to deny P the tax benefits that accrued from the formation of N.

> Section 269 of the Code provides, in general-- If --
>
> (1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or
>
> (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,
>
> and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

Section 1.269-3(a)(2) of the regulations provides that if the principal purpose requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of section 269 of the Code which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom.

There are three conditions for the application of section 269(a)(1) of the Code: (1) a person or persons acquire, directly or indirectly, control of a corporation, (2) the principal purpose for the acquisition is to evade or avoid Federal income tax, (3) by securing the benefit of a deduction, credit, or other allowance that would not otherwise be enjoyed.

The first requirement that persons acquire control of a corporation is satisfied. The creation of a new corporation may constitute an acquisition within the meaning of section 269(a)(1) of the Code. James Realty Co. v. United States, 280 F.2d 394, 399 (8th Cir. 1960); Borge v. Commissioner, 405 F.2d 673,677- 78 (2d Cir. 1968). See sections 1.269-1(c) and 1.269-3(b) of the regulations. The formation of N by O and M satisfies the acquisition of control requirement of section 269(a)(1).

The second requirement is that the acquisition must have had as its principal purpose the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy. To constitute the principal purpose, the purpose to evade or avoid Federal income tax must outrank, or exceed in importance, any other purpose. Canaveral Int'l Corp. v. Commissioner, 61 T.C. 520, 536; section 1.269-3(a) of the regulations. This is a question of fact, to be determined by considering all the facts and circumstances of the entire transaction, with the burden of proof on the taxpayer. J.T. Slocomb Co. v. Commissioner, 334 F.2d 269, 273 (2d Cir. 1964); section 1.269-3(a). Under this standard, the purpose that is relevant is the purpose which existed at the time of the acquisition, although facts occurring prior to and following the transaction may be considered to the extent that they tend to support or negate the forbidden purpose. Hawaiian Trust Co. v. United States, 291 F.2d 761, 768 (9th Cir. 1961).

However, even if the principal purpose for the formation of a corporation is to obtain certain tax benefits, such motivation does not constitute tax avoidance within the meaning of the section 269 of the Code if Congress intended to grant the benefit received. Modern Home Fire and Casualty Co., 54 T.C. 839 (1970). For example, creating a new corporation to carry on part of an existing corporation's business in order to qualify for the benefits of S corporation status is not tax avoidance for the purposes of section 269 of the Code. Rev. Rul. 76-363, 1976-2 C.B. 90. Similarly, incorporating an entity to take advantage of permitted tax benefits as a Western Hemisphere Trade Corporation, even though it was done for the principal purpose of obtaining tax savings, is not tax evasion or avoidance as contemplated by section 269. Rev. Rul. 70-238, 1970-1 C.B. 61.

In this case, the formation of N to take advantage of tax exempt status, even though formed for the principal purpose of obtaining tax savings, is not prevented by section 269 of the Code. Here, however, N did not qualify as an insurance company for any of the years involved, and can not avail itself of the exemption from tax provided by section 501(a).

Furthermore, the benefit obtained by P was not simply from the formation of N but from the transfer of the lease to N. Therefore, section 269(a)(2) of the Code rather than section 269(a)(1) is arguably the operative provision under which the Service might challenge the transaction. The asset transfer here, however, is not subjected to section 269(a)(2) because the property contributed to N, the lease, was controlled immediately before such acquisition by N's sole stockholder, O.

Therefore, section 269 of the Code should not be applied to prevent P from obtaining the benefit of the formation of N and the transfer of the lease to N.

CONCLUSIONS:

A. We conclude that N did not qualify as an insurance company for federal income tax purposes for the Years Involved.

B. N, a foreign company which made an election under section 953(d) of the Code, does not continue to qualify for exemption from federal income tax as an organization described in section 501(c)(15) of the Code, and revocation should be retroactive to Date 4, the date of its formation.

C. Since N is not an insurance company exempt under section 501(c)(15) of the Code, income earned by N during , , and then --

1. M must recognize gain pursuant to section 367as the result of the transfer of the Q lease to N.

2. Because N is a CFC, the subpart F regime will apply. In addition, the CFC may be a PFIC. In that case, the section 1291 regime will apply as well. Although the CFC will also qualify as a FPHC, there will be no FPHC tax consequences because where both the FPHC rules and the subpart F rules apply, subpart F takes priority.

3. If N is not an insurance company and its section 953(d) election is invalid, and N is an insurer or reinsurer and is therefore a "foreign insurer" as defined by section 4372(a) of the Code, it will be subject to the tax imposed by section 4371 if it issued policies of insurance or reinsurance to an "insured" as defined by section 4372(d). However, the facts provided are insufficient for us to determine whether the contracts retroceded to N by V as well as the check fraud contracts are insurance policies

D. The Service should not assert section 269 to deny P the benefits obtained from the formation of N.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

- END -