

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 6, 2004

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CASE-MIS No.: TAM-164536-03, CC:FIP:4

Taxpayer's Name:

Taxpayer's Address:
Taxpayer's Identification No
Year Involved:
Date of Conference:

LEGEND:

Taxpayer 1 =
Company 2 =
Taxpayer 3 =
State A =
Individual B =
Individual C =
Program D =
Year 4 =
Program Agreement =
Sponsor =
Administration Agreement =

Administrator =
Number E =
Insurance Contract =

Insurance Company =
Number F =

Dealer Agreement =

Group =

State G =

Trust =

Date 5 =

Date 6 =

Trustee =

Trust Administrator =

Liability Reimbursement Agreement =

Administrative Agreement =

Date 7 =

Jurisdiction H =

Jurisdiction I =

Number J =

Date 8 =

Protection Against Loss Agreement =

Number K =

Number L =

State M =

Date 9 =

Number N =

Number O =

Number P =

Number Q =

Number R =

Number S =

Number T =

Number U =

Number V =

Number W =

Number X =

Number Y =

Date 10 =

Number Z =

Date 11 =

Date 12 =

Number AA =

Number AB =

Number AC =
Case AD =

Statute AE =
Case AF =

This memorandum responds to your request for technical advice dated November 12, 2003. In addition to the issues set forth below, you asked whether Taxpayer 3 is entitled to the benefit of § 501(a) of the Internal Revenue Code for the year involved because it was an organization described in § 501(c)(15). That issue will be addressed under separate cover in a manner consistent with the conclusions in this memorandum.

ISSUE(S):

1. Were Taxpayer 3 a domestic corporation, would it have qualified as an insurance company under part II of subchapter L for the year involved?
2. Was Taxpayer 3 eligible to elect under § 953(d) to be treated as a domestic corporation? If not, how is the income of Taxpayer 3 accounted for under subpart F and other provisions that apply to foreign corporations?
3. Are the arrangements at issue a sham for federal income tax purposes?

CONCLUSION(S):

1. Were Taxpayer 3 a domestic corporation for the year involved, it would have qualified as an insurance company under part II of subchapter L.
2. Taxpayer 3 was eligible to elect under §953(d) to be treated as a domestic corporation.
3. The arrangements at issue were not a sham for federal income tax purposes.

FACTS:

Taxpayer 1 is a corporation chartered under the law of State A. It has two shareholders, Individuals B and C. For the year involved, Taxpayer 1 was an S corporation as defined by §1361(a). Taxpayer 1 sold new and used motor vehicles. In connection with this business activity, Taxpayer 1 offered for sale various vehicle

service agreements which provide purchasers, subject to certain limitations, with protection against economic loss for certain expenses related to the repair of the vehicle identified in the agreement which are not covered by the manufacturer's warranty. Among the agreements offered by Taxpayer 1 are agreements that are part of Program D.

Program D is designed to be a comprehensive program facilitating the sale and administration of vehicle service agreements implemented through several pre-arranged steps. Program D's Sponsor prepared literature for review by potential participants, including Taxpayer 1, describing the implementation and operation of Program D. Taxpayers' participation in Program D appears consistent therewith.

Taxpayer 1 began to participate in Program D in Year 4. Taxpayer 1 entered into Program Agreement with Sponsor. The Program Agreement states that the Program D Vehicle Service Agreements are contractual obligations of Taxpayer 1 and that performance of the Program D Vehicle Service Agreements will be the sole responsibility of Taxpayer 1, and that Sponsor will have no responsibility for the performance of the Program D Vehicle Service Agreements. Sponsor will act as the administering agent for the service agreements. The Program Agreement requires Taxpayer 1 to pay a nonrefundable service commencement fee and to remit to Sponsor on a monthly basis the amount indicated on the authorized dealer rate chart for each Program D Vehicle Service Agreement sold the previous month. Sponsor is required to provide Taxpayer 1 the service agreement forms and to provide the necessary administrative functions.

In order to fulfill its obligations under the Program Agreement, Sponsor entered into Administration Agreement with Administrator. The thrust of the Administration Agreement is that Administrator agrees to provide the personnel and systems to administer Program D, including coordinating the provision of contractual liability insurance for Program D participants; however, Administrator's obligations under the Administration Agreement specifically exclude any obligation to perform under the Program D Vehicle Service Agreements. Administrator will maintain the records regarding the Program D Vehicle Service Agreements, including the loss and accounting records, and will generate reports of Program D's operation. The Administration Agreement calls for each Program D participant to remit to Administrator a specific amount per Program D Vehicle Service Agreement sold. Upon receipt, Administrator will administer the in-force Program D Vehicle Service Agreement. The Administration Agreement was amended during the year involved. The amendments contemplated the addition of roadside assistance services and provided terms upon which Administrator would facilitate the provision of such services.¹ Additionally, the amendment contemplated that a reinsurance company affiliated with each participant in Program D would be formed. Each such company would be responsible for the

¹ During the year involved, the Program D Vehicle Service Agreements offered by Taxpayer 1 did not include roadside assistance services.

obligations of the participants in Program D under the Program D Vehicle Service Agreements; the company's assets would be available to Sponsor to satisfy the obligations to the participants under the Program D Vehicle Service Agreements.

Though the coverage terms of the Program D Vehicle Service Agreements vary (the variables include length of time or miles covered², the specific component parts of the identified vehicle, and the amount the purchaser has to pay per repair visit before the coverage applies (the "deductible")), the essence is common. The Program D Vehicle Service Agreements provide that the selling dealer (Taxpayer 1) will make necessary repairs to the specified component parts of the identified vehicle, which may include replacement, without additional cost to the customer. The Program D Vehicle Service Agreements do not cover any repair covered by the manufacturer's warranty, or failures from, among other things, collision, abuse, alterations outside the manufacturer's specifications, or lack of reasonable and proper maintenance.

Subject to limitations, the Program D Vehicle Service Agreements also provide reimbursement for transportation and towing costs incurred due to the breakdown of the identified vehicle. However, the Program D Vehicle Service Agreements do not cover any incidental or consequential damages. The total benefits payable pursuant to a Program D Vehicle Service Agreements cannot not exceed the price paid for the identified vehicle. If a customer believes that a component has failed in a manner covered by the Program D Vehicle Service Agreement, the customer is to deliver the vehicle to Taxpayer 1, or, if more than Number E miles from Taxpayer 1, call Administrator for instructions on how to proceed. If repairs are needed outside of normal business hours, the customer will be reimbursed the reasonable and customary charges for necessary repairs if Administrator is notified the next business day.

The Program D Vehicle Service Agreements terminate if the identified vehicle is repossessed or declared a total loss or if the customer gives notice of cancellation. In such event, a portion of the purchase price may be refunded to the customer, less a cancellation charge, if applicable. If the customer transfers the identified vehicle, the Program D Vehicle Service Agreement will terminate unless the customer applies to Taxpayer 1 to have the agreement transferred.

The Program D Vehicle Service Agreements are offered to Taxpayer 1's customers at the time a vehicle is sold. A Program D Vehicle Service Agreement is purchased with a single payment.

State A law includes warranty contracts covering motor vehicles within its definition of automobile insurance. However, State A law provides that agreements for which a separately stated charge is paid for coverage of only defects in material and workmanship that are sold incident to the business of selling or leasing automobiles are

² For a new vehicle, the maximum length of coverage was the first to occur of 84 months or 100,000 miles; for a used vehicle, 36 months or 36,000 miles.

deemed to not be insurance if the seller (other than a manufacturer, distributor, or importer) of the agreement has an insurance policy with an admitted insurer covering the agreements. This insurance coverage must provide – and the vehicle service agreement must conspicuously state - that a claim can be made against the admitted insurer if the seller does not perform within 60 days after proof of loss is submitted to the seller.

In order to satisfy the requirements of State A law for the Program D Vehicle Service Agreements to be deemed not insurance for state law purposes, Taxpayer 1 entered into Insurance Contract with Insurance Company, an insurer licensed in State A. Pursuant to Insurance Contract, Insurance Company agreed to pay such sums as are required to perform Taxpayer 1's obligations under the Program D Vehicle Service Agreements in the event Taxpayer 1 is unable. The coverage provided by Insurance Company under the Insurance Contract is limited to \$ Number F in the annual aggregate; for each covered vehicle, Insurance Company's liability does not exceed the actual cash value of the vehicle. In addition to exclusions for losses arising from acts of war and the like, the Insurance Contract does not cover any loss that is covered by the manufacturer's warranty, caused by delay in repair, in the nature of consequential damages, or less than the deductible amount stated in the Program D Vehicle Service Agreement. In accordance with the law of State A, the Program D Vehicle Service Agreements conspicuously reference the Insurance Contract.

Taxpayer 1 entered into Dealer Agreement with Administrator to ensure that the Program D Vehicle Service Agreements it sold were properly administered. In the Dealer Agreement, Taxpayer 1 recognized that "all services to be performed under [Program D Vehicle Service Agreements] will be provided by and are the sole responsibility of [Taxpayer 1]", that "the [Program D Vehicle Service Agreements] are the contractual obligations of [Taxpayer 1]", and that Administrator had no liability for such services. The Dealer Agreement calls for Taxpayer 1 to pay to Administrator an initial service commencement fee and then remit a monthly administrative fee along with a copy of each Program D Vehicle Service Agreement sold by Taxpayer 1 during the preceeding month. Administrator agreed to obtain and supply Taxpayer 1 with the Program D Vehicle Service Agreement forms and promotional material, and to provide administrative services, including the adjustment of claims made under the Program D Vehicle Service Agreements and arranging for service if repairs are needed more than Number E miles from Taxpayer 1 or outside of normal business hours.

To facilitate Taxpayer 1's performance of its obligations under the Program D Vehicle Service Agreements, Program D provides a mechanism which is intended to constitute a reinsurance arrangement. The arrangement is structured as follows: Taxpayer 1 joins Group. (Taxpayers provided a blank form application to join Group, but did not provide a completed application.) Group was chartered under the laws of State G for the purpose of purchasing liability insurance for automobile dealers. Group is not an insurance company. Group held itself out as being an insurance purchasing

group as defined by the Liability Risk Retention Act of 1986, 15 U.S.C. § 3901 et seq., 100 Stat. 3170 (1986), though it is unclear that for the year involved Group had made the filings required by the Act. The terms of membership in Group are that Group may subscribe to group policies for the benefit of members; however, neither Group nor its officers and directors were liable with respect to any such coverage. Sponsor is the manager of Group's vehicle service agreement program.

Prior to the year involved, Group's charter was revoked, apparently because it failed to pay the required state fees. Subsequent to the year involved, Group apparently cured this deficiency and its charter was reinstated.

Trust was chartered outside the United States on Date 5. Group became a member of Trust on Date 6. Whether Group authorized this membership and whether the signature on the document accepting membership on behalf of Group is authentic is unclear. The purpose of Trust is to provide a mechanism for its members to obtain group insurance. Trust's Trustee, a chartered business entity, was charged with being the custodian and holder of group policies issued to the Trust. Trust Administrator, a chartered business entity qualified to administer group insurance programs, agreed to assume the responsibility of all administrative duties in connection with any group policy issued to Trust. Trust granted to Trust Administrator the authority to make application on behalf of Trust to qualified underwriting companies for contracts providing various insurance coverages for the members of Trust. All premiums shall be paid to Trust Administrator. Trust Administrator is not authorized to incur any expense on behalf of a member of Trust; all expenses for service and material incurred in connection with administration of any group policy are to be borne by the underwriting company and/or Trust Administrator. Trustee shall not be responsible for the collection or remitting of premiums for such a policy, or responsible for its renewal, replacement, or cancellation.

To pursue the purpose of Group and Trust, an application for coverage was submitted to Company 2, a company chartered and domiciled outside the United States but not licensed as an insurer in any of the United States³. Acting on this application, on Date 6, Company 2 issued Liability Reimbursement Agreement to Trust. Though Trust authorizes Trust Administrator to apply for coverage, the application was signed by Group; no evidence that Group was authorized to make this application was presented. The Liability Reimbursement Agreement covers vehicle service agreements for which Company 2 approves the agreement form and which are administered by the company identified on the certificate evidencing coverage issued by Company 2. Only the entity named on the certificate evidencing coverage may receive the benefits provided by the Liability Reimbursement Agreement.

Company 2 entered into Administrative Agreement with Sponsor whereby Sponsor agreed to maintain all reinsurance files, calculate premium earnings, and fund

³ That Company 2 is a "qualified underwriting company" as required by the terms of the Trust has not been questioned.

all accounts in accordance with any reinsurance treaty, and provide quarterly statements.

An entity covered by the Liability Reimbursement Agreement must remit to Company 2 the amount “determined in accordance with the rates attached” to the Liability Reimbursement Agreement. In return, Company 2 will pay all sums the entity named on the certificate evidencing coverage becomes obligated to pay as claims under service agreements sold while the Liability Reimbursement Agreement is in effect, up to a maximum specified in the certificate evidencing coverage; the Liability Reimbursement Agreement provides that the amount payable under all covered contracts is subject to and shall be equal to the “current authorized rate chart that is in effect at the time the service agreement was issued.”

According to the Field and Taxpayers, the “rates attached” and “the current authorized rate chart” are the same and specify the amount that Taxpayer 1 is to remit to Sponsor for each Program D Vehicle Service Agreement Taxpayer 1 sells.

Taxpayer 1 is identified on a certificate evidencing coverage issued by Company 2, effective for the year involved; however, this certificate does not state a maximum coverage amount. There is no indication that Company 2 approved of the contract forms used by Taxpayer 1 to sell the Program D Vehicle Service Agreements.

On Date 7, Taxpayer 3 was incorporated as a company with its capital divided into shares under the laws of Jurisdiction H, which is outside the United States. Subsequent to its incorporation, and before the year involved, Taxpayer 3, was, as allowed by its Memorandum and Articles of Association, re-domesticated to Jurisdiction I, also outside the United States. During the year involved, Individuals B and C each owned Number J% of the shares of Taxpayer 3. Taxpayer 3’s Memorandum and Articles of Association allowed it, among other things, “to carry on all or any of the businesses as advisers, consultants, specialists, and experts on all matters relating to.....insurance” and “to undertake and carry on the business of all or any other kinds of insurances and to carry on all or any class of insurance or re-insurance business.” In addition, Taxpayer 3 was empowered to reinsure or counter-insure any risk it assumed; to carry on the business of an investment company to acquire, manage, and dispose of real or personal property; to lend money; and to deal in securities and negotiable investments that are the property of Taxpayer 3 or on behalf of others. Taxpayer 3 was authorized to apply for any license(s) required to conduct any of the authorized activities. The Memorandum and Articles allowed Taxpayer 3 to distribute among its members any of its property provided that any such distribution which reduced its capital could only be made as allowed by the applicable law. The Memorandum and Articles contemplated that Taxpayer 3 would conduct its business outside of its domicile.

On Date 8, which is before Date 7, Company 2 and Taxpayer 3 entered into Protection Against Loss Agreement. Under the Protection Against Loss Agreement, Company 2 agreed to assign, and Taxpayer 3 agreed to accept, all of Company 2's liability on each and every vehicle service agreement attached thereto. Taxpayer 3 assumed all of Company 2's risk. The Protection Against Loss Agreement contemplates that Taxpayer 3 will "follow the fortunes" of Company 2; the coverage provided by the Protection Against Loss Agreement is to be conterminous with that provided by the Liability Reimbursement Agreement and Company 2's decision to accept or reject a claim of coverage thereunder will be binding on Taxpayer 3. Upon submission of reasonable evidence of an amount paid by Company 2 which is covered by the Protection Against Loss Agreement, Taxpayer 3 will immediately reimburse Company 2 for such amount.

The consideration paid by Company 2 to Taxpayer 3 under Protection Against Loss Agreement is Number K% of the amount Company 2 received from Taxpayer 1 under the Liability Reimbursement Agreement less any amount Company 2 had to return to Taxpayer 1 due to cancellation(s) of a Program D Vehicle Service Agreement(s). This consideration is to be paid to Taxpayer 3 monthly; in making this payment, the Protection Against Loss Agreement allows Company 2 to offset against the amount to be remitted any amount Taxpayer 3 owes Company 2. In consideration for facilitating the Protection Against Loss Agreement, Taxpayer 3 agreed to pay Company 2 a commission of Number L% of the amount to be paid by Company 2 (without regard to any offset). Taxpayer 3 was required to provide collateral in a form acceptable to Company 2, such as a letter of credit, to secure its obligations under the Protection Against Loss Agreement. This was satisfied by having Company 2 act as a trustee over Taxpayer 3's assets. There is no indication that Taxpayer 1 or Individuals B or C directly or indirectly guaranteed Taxpayer 3's performance under the Protection Against Loss Agreement. The Protection Against Loss Agreement provides that it is to be interpreted in accordance with the laws of State M and that any inadvertent delay, error, or omission shall not relieve either party from its obligations; the parties agreed to correct any such delay, error, or omission as soon as possible after discovery.

Taxpayer 3 has no employees; any needed administrative tasks were accomplished as a result of the operation of the various agreements. During the year involved, reports of Taxpayer 3's activity were prepared, though no actuarial forecasts or analyses were created. Taxpayer 3 did not enter into any other contracts similar to the Protection Against Loss Agreement. From the date it was established through the year involved, Taxpayer 3's primary and predominant business activity was the Protection Against Loss Agreement. On Date 9, the Service issued a determination letter to Taxpayer 3, confirming that it was exempt from tax under § 501(c)(15) as an organization described by § 501(c)(15) ("Date 9 Determination Letter").

In practice, the various agreements were performed in this manner: at the time a customer purchased a vehicle from Taxpayer 1, the customer would purchase a

Program D Vehicle Service Agreement, paying in full the price the customer negotiated with Taxpayer 1. Taxpayer 1 remitted to Sponsor the amount specified on the rate chart⁴ monthly for all Program D Vehicle Service Agreements sold the previous month. The amount Taxpayer 1 remitted to Sponsor was computed on a “net-remit” basis. That is, Taxpayer 1 subtracted from the amount to be remitted to Sponsor the amount it incurred in performing its obligations under outstanding Program D Vehicle Service Agreements for which it had not been reimbursed. Sponsor in turn paid the fee owed Administrator under the Administration Agreement and the premium owed Insurance Company under the Insurance Contract. Sponsor remitted the remaining funds to Company 2. Company 2 then remitted this amount, less Number L%, to Taxpayer 3. It appears that approximately Number N% of the amount stated on the current authorized rate chart was remitted to Taxpayer 3. In accounting for the purchase price received, Taxpayer 1 used the methods allowed by Rev. Proc. 97-38, 1997-2 C.B. 479 and Rev. Proc. 97-37, 1997-2 C.B. 455.

Reports showing the activity of Taxpayer 3 during the year involved reflect the following: during the year involved, Taxpayer 3 issued Number O Program D Vehicle Service Agreements. Of this amount, Number P were for new vehicles and Number Q were for used vehicles. This brought the total outstanding Program D Vehicle Service Agreements covered by Taxpayer 3 since Taxpayer 1 began participating in Program D to Number R, of which Number S were for new vehicles and Number T were for used vehicles. In connection with this Number R outstanding Program D Vehicle Service Agreements covered by Taxpayer 3, \$ Number U had been remitted to Taxpayer 3. During the year involved, claims were made against Number V of the outstanding Program D Vehicle Service Agreements. The cost incurred by Taxpayer 3 pursuant to the Protection Against Loss Agreement for these claims was \$ Number W. Over the history of Taxpayer 3's involvement in Program D, the total Number of Program D Vehicle Service Agreements against which claims were made was Number X, for which Taxpayer 3 had to pay \$ Number Y.

On Date 10, Individuals B and C, as directors of Taxpayer 3, passed a corporate resolution directing that \$ Number Z of Taxpayer 3's funds be loaned to Taxpayer 1, payable by Taxpayer 1 with interest (“Date 10 Loan”). Also on Date 10, Taxpayer 1, by Individual B and Individual C as president and chief financial officer, respectively, executed a promissory note for \$ Number Z. This note was secured by used vehicles in Taxpayer 1's inventory and was personally guaranteed by Individual B and Individual C. It appears that Taxpayer 1 made regular payments on the Date 10 Loan until November of the year involved, at which time payments ceased. Subsequent to the year involved, on Date 11, Taxpayer 3 recovered the outstanding balance of the Date 10 Loan, including all accrued interest, by setting this balance off against amounts Taxpayer 3 owed Taxpayer 1. This set off was authorized by the Date 10 Loan documents.

⁴ Additionally, Taxpayer 1 would forward to Sponsor copies of the Program D Vehicle Service Agreements and any other documentation required by the various agreements.

On Date 12, Individuals B and C, as directors of Taxpayer 3, passed a corporate resolution directing that \$ Number AA of Taxpayer 3's funds be loaned to Taxpayer 1, payable by Taxpayer 1 with interest ("Date 12 Loan"). Also on Date 12, Taxpayer 1, by Individuals B and C as president and chief financial officer, respectively, executed a promissory note for \$ Number AA. This note was secured by used vehicles in Taxpayer 1's inventory and was personally guaranteed by Individuals B and C. Taxpayer 1 made three payments on the Date 12 Loan. Subsequently, all but \$ Number AB of the Date 12 Loan was recovered by Taxpayer 3 through an offset.⁵

On its balance sheet for the year involved, Taxpayer 3 improperly included as a liability an "asset valuation reserve", a concept associated with life insurance, when the coverage it provides is non-life. When this error in Taxpayer 3's balance sheet is corrected, Taxpayer 3's net equity at the end of the year involved was \$ Number AC.

LAW AND ANALYSIS:

1. Were Taxpayer 3 a domestic corporation, would it have qualified as an insurance company under part II of subchapter L for the year involved?

a. Law

This case is ultimately about whether for the year involved Taxpayer 3 was eligible for the benefit of § 501(a) because it was an organization described by § 501(c)(15) for the year involved. If Taxpayer 3 was eligible, its income was exempt from federal income taxation; if not, its income may be taxable to its shareholders under subpart F. Taxpayer 3's eligibility for the benefit of § 501(a) turns on whether it satisfies the criteria for qualification as an insurance company for federal income tax purposes.

For the year involved, for federal income tax purposes an insurance company is 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; § 816(a) (company treated as an insurance company for federal income tax 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). While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. 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); see also Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932). To

⁵ Taxpayers represent that set off did not pay the Date 12 Loan in full due to a clerical error in computing the payoff.

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 Taxpayer 3 engages in other trades or businesses, and its sources of income. See generally 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-Am. 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).

Taxpayer 3’s primary and predominant business activity during the year involved was performing under the Protection Against Loss Agreement. Taxpayer 3’s qualification as an insurance company depends on whether this activity constituted issuing an insurance contract or reinsuring the risks underwritten by an insurance company.

Neither the Code nor the regulations thereunder define the terms “insurance” or “insurance contract.” The bedrock for evaluating whether an arrangement qualifies as insurance is Helvering v. LeGierse, 312 U.S. 531, 539 (1941), in which the Court stated that “historically and commonly insurance involves risk – shifting and risk distributing.” Insurance has been described as “involv[ing] a contract, whereby, for adequate consideration, one party agrees to indemnify another against loss arising from certain specified contingencies or perils...[I]t is contractual security against possible anticipated loss.” Epmeir v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952). Cases analyzing “captive insurance” arrangements have distilled the concept of “insurance” for federal income tax purposes to three elements, applied consistently with principles of federal income taxation⁶: 1) involvement of an insurance risk; 2) shifting and distribution of that risk; and 3) insurance in its commonly accepted sense. See, e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff’g 96 T.C. 18 (1991).

The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir.), cert. denied, 439 U.S. 835 (1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. LeGierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs when a person facing the possibility of economic loss transfers some or all of the financial consequences of the potential loss to the insurer.

⁶ These principles include respecting the separateness of corporate entities, the substance of the transaction(s), and the relationship between the parties. Sears, Roebuck and Co. v. Commissioner, 96 T.C. 61, 101-02 (1991), aff’d, 972 F.2d 858 (7th Cir. 1992).

See Rev. Rul. 92-93, 1992-C.B. 45 (where parent corporation purchased a group-term life insurance policy from its wholly owned insurance subsidiary, the arrangement was held to be not “self-insurance” because the economic risk of loss was not that of the parent), modified on other grounds, Rev. Rul. 2001-31, 2001-1 C.B. 1348. If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance payment. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. See Clougherty Packing Co., 811 F.2d at 1300. Risk distribution necessarily entails a pooling of premiums, so a potential insured is not in significant part paying for its own risks. See Humana v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

The “commonly accepted sense” of insurance derives from all of the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that of known insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law, AMERCO, Inc., 96 T.C. 18, 41 (1991); the adequacy of the insurer’s capitalization and utilization of premiums priced at arm’s length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff’d 979 F.2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728 (1991), aff’d per curiam, 988 F.2d 1135 (Fed. Cir. 1993); and the language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. Commissioner, 49 Fed. Cl. 42, 51-52 (1997).

A contract providing benefits in kind, rather than in cash, may constitute an insurance contract for federal income tax purposes. Commissioner v. W.H. Luquire Burial Ass’n Co., 102 F.2d 89, 90 (5th Cir. 1939) (“The mere fact that the policy is payable not in money, but in something of value equal to money, does not, as a matter of law, exclude it from classification as an insurance contract.”); § 816(g)(burial or funeral benefit insurance company engaged directly in the performance of funeral services taxable as nonlife insurance company); § 1.213-1(e)(4) (“In determining whether a contract constitutes an ‘insurance’ contract it is irrelevant whether the benefits are payable in cash or in services”). But not all transactions which involve shifting and distributing an element of insurance risk qualify as insurance. Rev. Rul. 68-27, 1968-1 C.B. 315, held that an arrangement whereby an organization issued medical service contracts to various groups and individuals who prepaid the contract price at fixed monthly rates did not qualify as an insurance contract for purposes of the Code because

the risk assumed by the issuer with regard to therapeutic care was predominantly a normal business risk because the “organization generally does not incur any expense other than that which it incurs in providing the medical services through a salaried staff of physicians, nurses, and technicians.” See also, Johnson v. Commissioner, 108 T.C. 448, 472 n7 (1997) aff’d in part and rev’d in part, 184 F.3d 786 (8th Cir. 1999).

In Rev. Rul. 80-95, 1980-1 C.B. 252, an employer obtained coverage for its obligations under long-term disability benefits it promised its employees. The risk involved was the employees’ risk of loss from injury. The indemnifier was not directly liable to any individual employee. The ruling concluded that the indemnification agreement was a contract of sickness or accident insurance under § 4372(e) because the risk assumed by the indemnifier had the same character as that borne by the employer: injury to an employee. Whether the disability benefit plan qualified as insurance for federal income tax purposes was not dispositive.

In considering this arrangement we are mindful of the observation of the Court that interrelated contracts must be considered together. LeGierse, 312 U.S. at 540. See also Clougherty Packing Co., 811 F.2d at 1301 (“Where separate agreements are interdependent, they must be considered together so that their overall economic affect can be assessed.”)

b. Analysis

Here, as the literature prepared by Sponsor makes clear, the Program D Vehicle Service Agreements, the Liability Reimbursement Agreement and the Protection Against Loss Agreement are interrelated and interdependent; without the latter two, Taxpayer 1 would not have issued the former. Considered together in this case, the effect is to shift to Taxpayer 3 the risk of loss from the purchasers of the Program D Vehicle Service Agreements.

This shifting of risk can be effected only if genuine obligations are created by the operative documents. Under the facts presented, there were a series of defects in the execution of the Liability Reimbursement Agreement which call its enforceability into question. (No defects have been noted in connection with the Protection Against Loss Agreement entered into between Company 2 and Taxpayer 3.) The applicable choice of law rules result in the application of State A law to evaluate the validity and to interpret the Liability Reimbursement Agreement. See Case AD; Satori v. Commissioner, 66 T.C. 680, 689-90 (1976) (applying choice of law rules of forum state to evaluate existence of binding contract under §49). State A law recognizes implied contracts on terms manifested by the conduct of the parties, Statute AE. In this case, despite the defects noted, the parties conducted themselves as though the Liability Reimbursement Agreement was valid and enforceable. Company 2 made no effort to disavow the Liability Reimbursement Agreement. Rather, Taxpayer 1 paid premiums and Company 2 performed as called for by the Liability Reimbursement Agreement.

Once the parties became aware of the defects, the parties corrected them. Therefore, during the year involved we presume a legally enforceable contractual relationship between Taxpayer 1 and Company 2.

The nature of the risk assumed by Taxpayer 1 from the purchasers of the Program D Vehicle Service Agreements is an insurance risk: the purchaser bore a risk of economic loss for the cost required to repair (or replace) a specified failed component of the identified vehicle. Though this risk is shifted from the purchaser to Taxpayer 1 and distributed in a manner commonly accepted as insurance, because the Program D Vehicle Service Agreements obligate Taxpayer 1 to perform this service work directly, the Program D Vehicle Service Agreement is akin to an agreement not characterized as an insurance contract for federal income tax purposes. Rev. Rul. 68-27; Johnson, 108 T.C. 448, 472 n7.

Regardless of whether the Program D Vehicle Service Agreements are characterized as insurance contracts for federal income tax purposes, the nature of the risk covered is the same. In Rev. Rul. 80-95, the insurance risk arising from an employee's injury was initially covered by the employer's disability benefit plan; the ruling suggests that this plan was not insurance nor was the employer an insurance company for federal income tax purposes. The ruling's holding that the indemnification arrangement qualified as insurance reflects the economic substance of the arrangement: that the employees' insurance risk arising from injury was shifted and distributed.

Here, considering together the Program D Vehicle Service Agreement, the Liability Reimbursement Agreement, and the Protection Against Loss Agreement, the effect is to shift to Taxpayer 3 the risk of loss from the purchasers of the Program E Vehicle Service Agreements. For each Program D Vehicle Service Agreement sold, Taxpayer 1 remitted to Company 2 (via Sponsor) the amount indicated on the "authorized rate chart", less the fees of the Administrator and Insurance Company; the language of the Liability Reimbursement Agreement suggests that Company 2's liability to Taxpayer 1 was limited to the amount indicated on that chart.⁷ In the present case, a substantial portion of the amount on the rate chart is not paid to Company 2. Moreover, Taxpayers have produced examples of individual Program D Vehicle Service Agreements under which the amounts paid in claims exceeded the initial premium paid by the customer.

The risk of loss which is shifted ultimately to Taxpayer 3 and distributed among the large number of similar purchasers is an insurance risk and the coverage provided the purchaser is in accord with the commonly accepted sense of insurance. Therefore, the primary and predominant business activity of Taxpayer 3 is the issuance of insurance contracts; the fact that its operations are sparse does not negate this

⁷ Additionally, Taxpayers point out that under State A law, an insurance contract is to be interpreted so as to provide the greatest possible protection to the insured. Case AF.

conclusion. 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 § 801). Taxpayer 3 would have qualified as an insurance company were it a domestic corporation for the year involved. Because the insurance coverage provided is other than life insurance, Taxpayer 3 would have qualified as an insurance company taxable under part II of subchapter L.

In reaching this conclusion, we have considered the argument that the arrangement at issue involves only one insured (Taxpayer 1), and that the arrangement therefore cannot constitute insurance for federal income tax purposes because there is insufficient risk distribution. The risks in the present case, however, originated not with Taxpayer 1 but with the large number of unrelated customers of Taxpayer 1. The amounts paid by those customers to purchase Program D Vehicle Service Agreements were pooled, and those customers were indemnified for the repair of specified components of identified vehicles, either in cash or in kind. Had Taxpayer 3 issued the Program D Vehicle Service Agreements directly to the customers, the agreements collectively would constitute a block of insurance business for federal income tax purposes. Likewise, were Taxpayer 1 an insurance company, Taxpayer 3's role as a reinsurer would not be challenged. In this sense, the instant case is most analogous to Rev. Rul. 80-95, which characterized as insurance an arrangement between a single employer and a foreign insurer, based on the disability risks of a large number of unrelated employees. Our conclusion is also consistent with the legal analysis that formed the basis of the Date 9 Determination Letter. In short, the differences between the facts represented to the Service in support of the determination letter and those presented in this case do not in themselves alter the legal conclusion that Taxpayer 3 qualified as an insurance company for federal income tax purposes.

2. Was Taxpayer 3 eligible to elect under § 953(d) to be treated as a domestic corporation?

a. Law

The subpart F regime applies to foreign corporations that qualify as controlled foreign corporations (CFCs). Section 957 defines a CFC as a foreign corporation of 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 United States shareholders. A United States shareholder, in turn, is defined under § 951(b) as a U.S. person who owns 10% or more of the total combined voting power of all classes of the corporation's stock entitled to vote.

Section 951(a)(1)(A)(i) 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, in relevant part, insurance income, as defined by § 953, and foreign base company income, as defined by § 954.

Section 953(d) permits a foreign insurance company to instead be treated as a domestic corporation if –

(A) the foreign corporation is a CFC (defined by § 957(a) by substituting “25 percent or more” for “more than 50 percent” and by using the definition of United States shareholder under § 953(c)(1)(A);

(B) the foreign corporation would qualify under part I or part II of subchapter L for the taxable year if it were a domestic corporation;

(C) the foreign corporation meets such requirements as the Secretary prescribes to ensure the taxes imposed by Chapter 1, Subtitle A of the Code are paid; and,

(D) the foreign corporation makes an election under this paragraph and waives all benefits to the corporation granted by the United States under any treaty.

b. Analysis

In the present case, the parties represent that the requirements of § 953(d)(1)(A), (C), and (D) are met, such that Taxpayer 3 will be treated as a domestic corporation for the year involved if it would qualify under part I or part II of subchapter L. For the reasons explained above, we have concluded that Taxpayer 3 would have qualified as an insurance company under part II of subchapter L. Accordingly, the requirement of § 953(d)(1)(B) is met in this case, and Taxpayer 3 is treated as a domestic corporation for the year involved.

3. Are the arrangements at issue a sham for federal income tax purposes?

a. Law

Transactions may be shams in fact or shams in substance. A sham in fact is a transaction that was created on paper but did not actually occur. A sham in substance is a transaction that actually occurred but which lacks the substance suggested by its form. Kirchman v. Commissioner, 862 F.2d 1486, 1492 (11th Cir. 1989).

Where a transaction in fact occurs, it will not be recognized for federal income tax purposes if it lacks economic substance. Gregory v. Helvering, 293 U.S. 465, 469 (1935); In re: CM Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002). The evaluation of the economic substance of an arrangement focuses on two related factors: economic substance apart from tax consequences and business purpose. Am. Elec. Power Co.,

Inc. v. United States, 326 F.3d 737, 741 (6th Cir. 2003)(quoting Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989)) cert. denied, -- U.S. --, 124 S.Ct. 1043 (2004); In re: CM Holdings, Inc., 301 F.3d at 102; Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313, 1316 (11th Cir. 2001), cert. denied 535 U.S. 986 (2002); United Parcel Serv. of Am., Inc. v. Commissioner, 254 F.3d 1014, 1018 (11th Cir. 2001). In considering these factors, the arrangement must be viewed as a whole. ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998).

b. Analysis

Notwithstanding the defects in executing some of the documents at issue, the facts in the present case establish that the transaction(s) between Taxpayer 1, Company 2, and Taxpayer 3 did, in fact, occur. Customers unrelated to Taxpayer 1 paid amounts for Program D Vehicle Service Agreements which indemnified them for the repair of specified components of their identified vehicles. Some portion of these amounts remained with Taxpayer 1. The remainder (after payment of the fee owed the Administrator and the premium owed Insurance Company) was paid to Taxpayer 3. The pricing of the amount paid to Taxpayer 3 is not at issue in this case, nor is the fact that Taxpayer 3 bore the cost of covered repairs under the net-remit system. When the defects in execution were discovered, none of the parties to the affected agreements attempted to disavow them. To the contrary, they continued to perform under the terms of the agreements, and cured the defects as appropriate. Under the state law discussed above, a party's failure to perform would have been held a breach. Under these circumstances, we cannot conclude the insurance transactions did not take place. Therefore, the arrangement is not a sham in fact.

Nor is the arrangement a sham in substance. The arrangement between Taxpayer 1, Company 2, and Taxpayer 3 has both a business purpose and economic substance. Taxpayers established that the business purpose of Taxpayer 3 is to allow Taxpayer 1 to enter into the market with vehicle service contracts on which it is the obligor while providing a mechanism to facilitate and ensure the performance of Taxpayer 1's obligations thereunder; the economic substance is to provide for the insurance risk covered under the Program D Vehicle Service Agreements by creating a separate source of funding to ensure those obligations can be met, i.e., insurance. In this sense, the present case is like United Parcel Serv. of Am., Inc. v. Commissioner, 254 F.3d 1018-19 (11th Cir. 2001), which concluded that the creation of a genuine obligation in the nature of insurance has economic effect and an arrangement figuring in a bona fide, profit-seeking business has a business purpose. The present case is unlike either Winn-Dixie Stores, Inc., 254 F.2d 1313, or ACM Partnership, 157 F.3d 231, in that the substance of the arrangement – ultimately, providing insurance to the customers of Taxpayer 1 – comports with its form. The arrangement satisfies a business need of Taxpayer 1 and provides the opportunity to derive a pretax profit.

The conduct of the parties in this case is different from that of the taxpayer in Wright v. Commissioner, T.C. Memo. 1993-328, 66 T.C.M. (CCH) 214. In that case, the arrangements lacked formality and the taxpayer was careless in implementing and operating a purported reinsurance structure. Excess income was diverted to the purported reinsurance company and that company's funds were co-mingled with the taxpayer's. The purported reinsurance company's reserves were not computed using appropriate actuarial techniques and the company reported a negative surplus. The purported reinsurance company did not retain documents evidencing transactions entered into. In contrast, accounting and corporate formalities were observed in the transactions involving Taxpayer 3. The arrangement was not used to create or manipulate insurance reserves for the purpose of inappropriately sheltering income. Though distributions of Taxpayer 3's funds were made, it does not appear that Taxpayer 3 was treated like a "personal bank account".

Finally, the arrangement involved contractual relationships with unrelated third parties and did not involve the circular flow of cash. For all these reasons, the arrangement is not a sham for federal income tax purposes.

CAVEAT(S):

This technical advice memorandum does not address:

1. Taxpayer 3's entitlement to the benefit of § 501(a) for the year involved as an organization described in §501(c)(15);
2. the propriety of the method of accounting used by Taxpayer 1, Company 2, and Taxpayer 3 to reflect their involvement in Program D;
3. the treatment of any of the transactions described herein as constituting distributions by Taxpayer 3 or compensation of Individuals B or C; or,
4. any other legal issue other than those articulated at the top of this memorandum.

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