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ACTION ON DECISION

Subject: Trans City Life Insurance Company v. Commissioner,
106 T.C. 274 (1996)
T.C. Dkt. Nos. 23678-93, 16934-94

Issue:

Whether the Commissioner committed an abuse of discretion in determining that certain reinsurance agreements between unrelated parties had a "significant tax avoidance effect" within the meaning of I.R.C. § 845(b).

Discussion:

During the 1989-1992 tax years, the petitioner was an insurance company. Petitioner's primary and predominant business activity was writing credit life and disability insurance policies. In 1988 and 1989, the petitioner entered into two reinsurance agreements with an unrelated insurer. The Commissioner determined that each of the reinsurance agreements created a significant tax avoidance effect within the meaning of section 845(b). The significant tax avoidance effect was that the agreements enabled the petitioner to qualify as a life insurance company under I.R.C. § 816 and, in turn, to benefit from the small life insurance company deduction under I.R.C. § 806(a). To eliminate the significant tax avoidance effects, the Commissioner disallowed the petitioner's small life insurance company deductions for its 1989-1992 tax years.

The Tax Court held that the Commissioner may rely on section 845(b) prior to the issuance of regulations but had committed an abuse of discretion in determining that each of the reinsurance agreements had a significant tax avoidance effect.

Section 845(b) provides that if the Secretary determines that any reinsurance contract has a significant tax avoidance effect on any party to such contract, with respect to risks reinsured on or after December 31, 1984, the Secretary may make proper adjustments to eliminate the tax avoidance effect.

A tax avoidance effect is significant "if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties." H. Conf. Rept. 98-861, at 1063; 1984-3 C.B. (Vol. 2) at 317. In determining whether tax benefits enjoyed are disproportionate to risk transferred, the Secretary should examine the economic substance of the transaction taking into account factors such as seven nondeterminative factors described in the conference report. H. Conf. Rept. 98-861, supra at 1063. 1984-3 C.B. (Vol. 2) at 317.

In holding that each of the reinsurance agreements did not have a significant tax avoidance effect, the court concluded that six of the nondeterminative factors favored the petitioner and that one factor was neutral. The court also considered, as eighth and ninth factors, risk transferred versus tax benefits derived and State determinations on risk transfer. The court concluded that these factors favored the petitioner.

Central to its determination that the eighth factor favored the petitioner is the court's statement that, for purposes of section 845(b), "risk" is defined as the difference between the face value of the policies associated with the reinsurance agreement and the related reserves. The court rejected the Commissioner's position that the proper measure of risk is the probability of loss rather than the possibility of loss.

The Service agrees with the court that abuse of discretion is the appropriate standard of review under section 845(b). The Service further agrees that section 845(b) is constitutional in the absence of regulations and may be applied in the context of the small life insurance company deduction under section 806(a).

The Service disagrees with the court's factual finding of abuse of discretion in this case. The Service also disagrees with the court's apparent characterization of the economic substance test of section 845(b), "risk transferred versus tax benefits derived," as only a factor to be used in the determination of whether a significant tax avoidance effect exists. The Service also disagrees with the court's definition of "risk," in the overriding economic substance test of section 845(b), in terms of the amount of risk, or the

possibility of loss, rather than the amount at risk, or the probability of loss.

Recommendation:

Nonacquiescence

Reviewers:

JH

MS

DAB

/s/

LBS

NANCY S. VOZAR
Attorney

Approved: STUART L. BROWN
Chief Counsel

/s/

By:

JUDITH C. DUNN
Associate Chief Counsel

(Domestic)

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