Office of Chief Counsel
Internal Revenue Service
memorandum
CC:FIP:BR4:WTSullivan

date: 10\14\05

to: Robert C. Harper, Jr.
Manager, EO Technical Group 3
T:EO:RA:T:3

from: Donald J. Drees, Jr.
Senior Technician Reviewer
(Financial Institutions & Products)

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subject: [redacted] (the Applicant)

This memo provides our comments with respect to your April 29, 2005, assistance request. You concluded that the Applicant was not involved in an insurance arrangement, and, thus, did not qualify for exemption under §501(c)(15). Your primary rationale is that the overall transaction failed to meet the requirements of insurance (i.e., risk shifting and risk distribution were not present). Further, you go on to state that the principles of Rev. Rul. 2002-89, 2002-2 C.B. 984 (Situation 1), involving a parent/subsidiary captive insurance arrangement, are applicable to the Applicant's arrangement. Your secondary rationale is that because the Applicant was engaged in "providing mortgage loans to its sole shareholder" this indicates that the Applicant is "not primarily engaged as an insurance company." We disagree with both your arguments. In brief, we do not see a captive insurance related issue in this case and the kind of loan involved here, by itself, is not sufficient to cause the Applicant to fail to qualify as an insurance company.

We also note the possible existence of an "audit" issue involving an erroneous method of accounting which if corrected would increase the Applicant's net written premiums beyond the $350,000 level for [redacted]

Certain Facts

The Applicant was formed under the laws of the [redacted] in [redacted] to act as a reinsurer of credit life, disability and certain property insurance written by companies issuing such policies to insureds who purchase furniture from the [redacted] [redacted] The Applicant was dissolved on [redacted] (We have no indication of a Form 990 being filed for the Applicant's short year ending on [redacted] All of the shares of stock of the Applicant are owned by [redacted] [redacted] A trust for the benefit owns [redacted]% of the shares of [redacted] stock measured by the total number of shares outstanding; however, [redacted] sister [redacted] has voting control of [redacted] [redacted] husband, [redacted] is active in [redacted] business.

The file contains the version of the reinsurance agreement that the Applicant used beginning in ████. Under the ████ reinsurance agreement, the Applicant acted as a reinsurer of ████, which was stated to be an insurer under the laws of the ████. Under the agreement, the Applicant agreed to automatically accept from ████ each and every credit life, credit disability and credit property policy produced by ████. We understand that the property insurance covers such things as fire damage to the financed furniture in the residence of the insured purchaser. The reinsurance agreement applies to policies or certificates issued by ████, as the ceding company on or after the ████ ████ Effective Date in respect of the insureds generated by the accounts of ████. The cessions by ████ were subject to the following specifications: (a) ██% of the first $████ of benefits for each life insurance policy, (b) ██% of the first $████ of monthly benefit for each accident and health insurance policy and (c) ██% of all benefits for each property insurance policy ceded.

The Applicant has indicated that ████ is no longer the ceding company with respect to the reinsurance arrangement. However, the Applicant has submitted the credit life, credit disability and credit property policy forms issued by two domestic domiciliaries who are direct writing insurers of the credit policies. We assume that these two direct writing insurers were subject to the reinsurance agreement most currently in use prior to the Applicant's dissolution on ████. The sample policies supplied are assumed to be issued by two companies within the ████ (which also contains companies using the ████ name). More specifically the two companies are: ████, which files a ████ National Association of Insurance Commissioners (NAIC) annual statement blank as an ████ domiciliary and ████ ████, which files a ████ NAIC annual statement blank as a ████ domiciliary.

The policies contain a credit life, credit disability and a property segment. The policies issued by ████ and ████ clearly indicate that they are consumer credit insurance policies (e.g., credit life insurance) where the debtors who are the insureds are consumers buying on credit.

There are a number of pieces of information that have not been made available to us and, thus, solely for purposes of this memorandum, we will make certain assumptions. For example, we have been given a copy of the ████ reinsurance agreement and for purposes of this memorandum, we are assuming that it has not been amended with respect to the ████ tax years other than the change in the names of the ceding companies (from a ████ company named in the ████ agreement to ████). While we do not have a document on the matter, the ████ employee, who is also in charge of the Applicant's records, indicated that the average loan term for the furniture financed by ████ which is the subject of the credit insurance provided by the direct writing companies (████), is ████ to ██ months.

Law and Analysis

Section 501(c)(15) recognizes insurance companies or associations other than life (including underinsures and reciprocal underwriters) as exempt if net written premiums (or if greater, direct written premiums) for the taxable year do not exceed $350,000 for years prior to January 1, 2004.

Qualification as an insurance company must be satisfied annually. Section 1.801-3(a)(1) of the Income Tax Regulations; 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). Section 1.801-3(a)(1), for the tax years under consideration, defines the term "insurance company" to mean a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsurance 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 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. at 877. However, investment activities are critical to an insurance company's business. See United States v. Atlas Insurance Co., 381 U.S. 233, 247 (receipt of premiums [by an insurance company] necessarily entails the creation of reserves and additions to reserves from investment income). 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 the 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 District of Columbia, 28 B.T.A. 1079, 1085-86 (1933).

We view your primary argument as an attempt to characterize the overall transaction as a captive insurance arrangement based upon the notion that the Applicant is reinsuring the risks of [redacted] and you see some "common" ownership between the two entities. Namely, [redacted] owns all of the stock of the Applicant and, through his beneficial interest in a trust, [redacted]% of the stock of [redacted] We understand, however, that [redacted] sister, [redacted] has voting control of [redacted] Quite aside from the difficulty that arises because [redacted] has no control of [redacted], the problem

with your approach is that the predominant risks reinsured by the Applicant are not risks, but those of its credit customers. While is listed as the "primary" beneficiary on the credit insurance policies written by the direct writing fronting companies, it is only technically so. The economically significant party under the credit insurance policy is the individual debtor, thus, we do not have a captive arrangement, rather is best characterized as a mere "producer" of credit insurance. Your secondary argument deals with the Applicant providing a mortgage loan.

We believe that the mere "producer" role is an especially good fit to explain function in this case. That is, we understand that credit customers purchased the insurance with separate consideration (apart from amounts used to purchase the furniture) and the event of death or disability of the customer/debtor or loss of the furniture purchased (e.g., fire or theft) the debtor or his estate will own the furniture free of any security interest. (Alternatively, in certain instances the credit insurance policyholder will receive cash proceeds.) In the credit life area, the courts have long dealt with situations where a debtor has irrevocably assigned a policy to his creditors as security for a debt. Even where the value of the debt currently exceeds the face value of the policy, the courts in certain contexts (e.g., §264) find a benefit to the policyholder based on the fact that if the policyholder dies before the debt is liquidated, his estate would benefit to the extent that the liabilities were reduced. Jefferson v. Helvering, 121 F.2d 16, 18 (C.A.D.C.). In Rev. Rul. 68-5, 1968-1 C.B. 99, a corporation's receipt of a Small Business Administration (SBA) loan was conditioned upon the corporate borrower assigning life insurance on the lives of its officers from the corporation to the SBA. The beneficiary under these policies was the SBA to the extent of its interests with the balance, if any, to the estate of the insured. The corporation was denied a deduction for the premiums paid under §264 because upon the death of any of the corporate officers the proceeds would be used to liquidate any of the corporate obligations remaining on the SBA loan. Finally, your attention is directed to the "economic realities" analysis in North Central Life Ins. Co. v. Commissioner, 92 T.C. 254, 270-272 (1989), which gives some indication how the Tax Court would evaluate whether the creditor or the debtor is the more significant party in a credit insurance situation.[1] In this connection, the following language from North Central (92 T.C. at 271) is instructive:

> ...[A]lthough the account was the primary beneficiary, [North Central] relieved the insured or the insured's estate of the credit obligation in the event of the insured's death or disability. For example, if the insured purchased insurance covering an installment obligation arising from the purchase of an automobile, then, in the event of the insured's death during the term of the insurance, his estate could distribute the automobile free of any debt without

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[1] The technical issue in North Central was whether North Central's "retroactive rate credits" were deductible as "dividends to policyholders," "return premiums," or "commissions." The Tax Court concluded that the amounts were neither dividends to policyholders nor return premiums, but that North Central was entitled to a deduction for compensation allowable under §162 and therefore deductible under § 809(d)(11)

reducing his estate's other assets. Consequently, in handling his estate, the insured determined the real beneficiary of the policy.

We believe that the above authorities illustrate that the elimination (or reduction) of the debt, even if it occurs at the debtor's estate level can make the debtor a significant beneficiary of the credit life policy.

Even assuming that [redacted] risks were reinsured by the Applicant, there is not the kind of significant common ownership that would support a "captive" analysis under the case law. [redacted] owns no stock of the Applicant. As mentioned above, the only shareholder of the Applicant is [redacted] While [redacted] has some beneficial ownership in [redacted] as a beneficiary of a trust, we are assuming that he has no effective voting power in [redacted] as such voting control vests in his sister, [redacted] In terms of the case law, we do not see a significant overlap in this particular case. In Crawford Fitting Co. v. United States, 606 F. Supp. 136 (1985), the Crawford Fitting Company (Crawford) was wholly owned by Fred Lennon, who also owned 50% or more of the stock of four warehouse corporations. The remainder of the stock was owned by either Lennon's wife or daughter. The four warehouse corporations each owned 20% of the "captive." The remaining 20% of the captive's stock was owned equally by three high-level employees of Crawford and its long-time outside counsel. The captive primarily insured Crawford, Lennon, members of Lennon's family, and numerous corporate and individual members of the Lennon group. The District Court noted that Crawford was not the parent company of the captive and stated that the fact that Lennon owns Crawford and a percentage of the warehouses does not mean that the warehouses' 80% ownership interest in the captive is the same an 80% ownership interest by Crawford. Further, the court noted that any gain or loss enjoyed or suffered by the captive does not affect the net worth of Crawford. Ultimately, the court distinguished former Rev. Rul. 77-316, 1977-2 C.B. 53 (dealing with wholly owned captive insurance subsidiaries), and concluded that an insurance relationship existed and allowed Crawford's §162 deduction for the amounts paid as premiums. In sum, we do not believe this case evidences the kind of common ownership through stock to support a conclusion that the transaction is not an insurance arrangement.

Your secondary argument urges that the Applicant by "providing loans to its sole shareholder" indicates that it is "not primarily engaged as an insurance company." We do not understand the loan to be a mortgage loan so referring to it as a mortgage loan is not technically correct. The loan document that we have been provided indicates the loan was an unsecured demand note with an interest rate set at 0.5% above the prime lending rate.

The arrangement that the Applicant is engaged is the reinsuring of credit life, credit accident and health, and credit property insurance primarily covering the risks of the purchasers of furniture (and other related merchandise) which is financed. We believe that this clearly constitutes an insurance arrangement. While the demand loan to [redacted] represents a significant portion of the Applicant's assets, credit insurance, generally, has low loss ratios. Further, the Applicant's underwriting activities during the

period under consideration have been profitable with no need to invade the Applicant's surplus. Indeed, that surplus has grown substantially during the period under consideration. Thus, we do not believe that there is any substantial risk that the Applicant would be unable to pay its ceding companies for the Applicant's obligations under the reinsurance agreement even in the unlikely event that totally defaulted on the demand note. Further, we have been provided no indication that would be unable to satisfy the Applicant's demand for a full and complete (principal and interest) payment on the note.

We would like to bring to your attention the potential application of section 1.832-4(a)(5) of the regulations to the calculation of net written premiums and direct written premiums. We focused on these regulations in this case because of the misdescription by the Applicant in Statement 4 of the Form 990s. For example, in Statement 4 – Form 990, Part IV, Line 58 –Other Assets for , there is an item entitled "Due from Reinsurer" with two entries, a Beginning of Year figure of $ and an End of Year figure of $ The inconsistency is that the Applicant is setting up as an asset Due from Reinsurer when it is itself the reinsurer in this transaction. We have ascertained that the term Due from Reinsurer was really a misnomer and that what the Applicant meant to say was Due from Reinsured. So what the End of Year entry presented was the $ owed to the Applicant from the direct writer ( ) with respect to credit insurance policies written and effective in for which the Applicant , as the reinsurer under the % automatic reinsurance agreement was entitled. The actual $ in cash was not received by the Applicant until early We have not ascertained whether or not the Applicant brought this $ amount into net premiums written prior to booking this amount as an asset in Statement 4. However, to the extent that the Applicant did not, it is not entitled to treat itself as a cash basis taxpayer, but should have brought this $ into premium income for An example may be helpful. If on December 1, 2001 sold a piece of furniture (which, in part, was financed) and the credit insurance had an effective date of December 1, 2001, then under §1.832-4(a)(5) of the regulations the direct writer (and the Applicant to the extent of its 50% share) would be in receipt of gross premiums written for 2001. Section 1.832-4(a)(5) provides, in general, that an insurance company reports gross premiums written for the earlier of the taxable year that includes the effective date of the insurance contract or the year in which the company receives all or a portion of the gross premium for the insurance contract. (Underlining supplied.) Under these assumptions the proper audit adjustment would be to change the Applicant's method of accounting for gross premiums written for the 2001 year of change. This would require that the Applicant include an additional $ into premium income for resulting in the Applicant's premium income, under the corrected method of accounting, being $ ($ + $). In addition, the examiner should obtain, as a "second" step, a §481(a) adjustment for the year of change. See Section 2.05(1) of Rev. Proc. 97-27, 1997-1 C.B. 680, 682 (Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method of accounting used to compute taxable income for the preceding taxable year). Usually when a taxpayer is on the cash

method and goes to a method requiring earlier reporting of income, a positive adjustment of the taxpayer's income is indicated.

If you have any questions concerning this memo, please contact Bill Sullivan, CC: FIP:4 at (202) 622-7052.