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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?" ... Here's what I'd say:

#1. A "KINDER & GENTLER" IRS? ... DEALERS WITH PORCs & OTHER INSURANCE ARRANGEMENTS MAY NOT THINK SO. The IRS shocked dealers who are involved with Producer Owned Reinsurance Companies (PORCs) when, on October 15, 2002, it released Notice 2002-70. This issue of the *Dealer Tax Watch* focuses on Notice 2002-70 and its implications for dealers and their advisors.

In this Notice, the IRS said that there were three possible attacks that the IRS might mount against PORC arrangements.

Not only that, the IRS said that these PORC-type arrangements claiming benefits under certain Code Sections are ***"listed"*** transactions. And that means that they require special disclosures in all related income tax returns.

"Direct" versus "indirect" participation ... arrangements which are "similar"—or "*substantially* similar"—to those described ... the dates and years in which the transactions were undertaken ...even the definition of what a ***"transaction"*** is ... all add to the complexity of the Notice and the Regulations.

The release of Notice 2002-70 created much concern and confusion one week later at the AICPA National Auto Dealership Conference in Orlando. It has continued to create uncertainty since then.

We are aware of at least one industry working group that is attempting to "educate" the IRS further with the aim of gaining exclusion from the disclosure/reporting requirements for the majority of dealer PORC arrangements that are properly structured and managed.

In the meantime, by virtue of its edict in Notice 2002-70, the IRS will be looking for some type of disclosure in the income tax returns of dealers, their corporations and other related PORC entities. But *just what kind of disclosure, which Regulations apply*, and *how much disclosure is required* are enormously complicated questions. And, guess what? If you're preparing the tax returns for a dealer in the next few months, you're going to have to wrestle with these questions as best as you can.

WATCHING OUT FOR

LOOKING FOR ADDITIONAL & "VALUE ADDED" SERVICES FOR DEALER CLIENTS?

Look no further... Just use the *Dealer Tax Watch* for a head start in golden consulting opportunities and activities to help dealer clients—and, in the process, to help yourself.

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It seems to boil down to two general problems. First is the problem of whether your specific dealer's PORC arrangement is a listed or reportable transaction. Second, what disclosures, if any, need to be made in the tax returns?

Unfortunately, the answers may not be forthcoming before the CPA needs to complete the tax return. Obviously, these issues need to be addressed in advance with the dealers who also will be signing those tax returns.

Multiple year disclosures. Not only are there questions about the disclosure statements to be filed with the current (i.e., year 2002) income tax returns, but what about prior years? ... If there's a need to disclose something in the 2002 tax return, there probably was a corresponding disclosure requirement for the prior years. This is just one more problem that CPA tax return preparers have to deal with.

Has the IRS overstepped its bounds in this dealer-sensitive area? Remember *Mountain State Ford* and the positions taken by the IRS regarding its disallowance of the use of replacement cost for valuing parts inventories? Remember the issues raised by the IRS over how detailed the LIFO conformity disclosures were supposed to be in year-end statements? In both cases, the IRS ultimately softened its position dramatically.

One could be hopeful that the position initially taken by the IRS on dealer PORCs in Notice 2002-70 will eventually be retracted or softened significantly by virtue of more careful elaboration by the IRS of what type of arrangement it really wants to treat as reportable/listed transactions.

However, until these concerns are resolved, the CPA still ends up either putting a disclosure statement in a tax return (where PORCs are involved) or leaving it out.

As we go to press. We have been informed by Terri S. Harris, the IRS Motor Vehicle Technical Advisor, that her office is working on an *Automotive Alert!* that will be devoted to Notice 2002-70. It is not yet available. She also indicated that her office was working with Chief Counsel's office to obtain further clarification and guidance on certain matters.

Also at this time, IRS Form 8886 for reporting post-2002 transactions has not been released by the IRS either.

Clearly, CPAs will be under the gun to prepare tax returns in the next 75 or more days. They will have to do something. But what?

#2. HERE'S WHAT I'D DO ... I'D PUT <u>"SOMETHING" IN THE TAX RETURN</u>. I've got a great deal of sympathy for any CPA whose dealer has a PORC arrangement and who's reading this right now and wondering what to do.

Let's consider what we know: First, we can't wait forever for the IRS to clarify things. Even if we could, that clarification might not be favorable ... or, more realistically, it might not cover many of the existing PORC arrangements that really are pushing the limits.

Second, it's unlikely by the time you've got to file a tax return that Form 8886 will be available. Even if it is, it is not likely to give you any magic answers. Third, you're not supposed to use that Form for reporting transactions that took place before 2003 anyway!

I've been a CPA preparing tax returns for over 40 years. For many of them, I've been involved with auto dealers, some of whom have gotten involved in all sorts of dicey arrangements. Usually, they are hoping to end up with more "after taxes" as a result of whatever arrangement they've undertaken. Every promoter trying to sell them something tells the dealer to "run it by your tax advisor," and the buck is supposed to stop somewhere. But where?

So what would I do if ... I had no more information ... and I had to file a tax return?

Unless the dealer were significantly at risk by being involved with questionable transactions, I'd put a statement in each tax return filed. This would be a ***protective*** statement. Therefore, if disclosure were technically required, it would be in the return and there would be compliance.

Now one school of thought is that it's foolish to volunteer anything to the IRS unless you're absolutely certain that you have to.

On the other hand, if it's not clear from the Regs whether disclosure is required, what's the harm in adding one more piece of paper to an already thick tax return? Will the IRS ever read it anyway?

In the course of trying to cope with these technicalities, I dreamed that it would be nice if only there were one simple form that could be used for all situations. Well, folks, there isn't any. But if there were, I have some thoughts about what it might say and how it might disclose my dealer's (hypothetical) PORC arrangement. You'll find what remained after I awoke on page 24.

#3. BY THE WAY, DON'T TAKE THE RAP <u>ALL BY YOURSELF</u>. But, that's not all. If the dealer were forcing me, as the tax return preparer, to contend with the tax consequences of ***<u>his</u>*** PORC →

arrangement, I'd want to be as certain as possible that all of us were singing off the same page. Therefore, I'd prepare the disclosure statement in draft, and if I were the staff CPA, I'd first get my manager or partner to approve it.

Then, I'd fax the statement in draft form to the promoter and have him sign off on it. He might even spruce up the language to embellish the responses. On the other hand, he might strenuously oppose any disclosure. (If that's the case, what might this be telling you?)

At the same time–or maybe even before faxing the draft of the disclosure statement to the promoter–I'd show the draft to the dealer so that he wouldn't be surprised at what was going on. Some dealers might even want to get their attorney's opinion on what was being said or whether or not it should even be said.

Does this seem like a lot of work, a "committee" project or even overkill? Before you answer, read the Regulations, including all the penalty language carefully. You'll note that there's even a place on the draft of the disclosure statement to record the involvement of the cast of characters mentioned above.

Having been in situations like this before, I've learned that you can't be too careful. Involve all of the interested parties well in advance of the time when you file the tax return. Sometimes the facts as you think you understand them might be just a little different from the real facts.

Finally, please read the caveat on the last page of this and every other issue of the *Dealer Tax Watch.* It states clearly that the contents are intended for general information purposes only and that readers (you) should consult their Certified Public Accountants, attorney, and/or other competent advisors to discuss their own situations and specific ... tax questions.

#4. NADA CONVENTION. Do you want to expand your dealership practice and learn more about the industry and what's affecting dealers and dealership operations? If you do ... *and of course you do* ... you can't afford to miss the 2003 National Automobile Dealers Association Convention and Exposition in San Francisco on February 1-4, 2003.

One of the most effective ways you can get a dealer's attention and establish your own credibility is to tell your dealer clients that you've just come back from the NADA Convention where you picked up some great money-saving ideas that you'd like to discuss with them.

If you can't say that, you can be sure of one thing. There are plenty of other CPAs who will gladly tell your client that he or she should be talking to them, instead of to you. That's the real world.

#5. TRADE DISCOUNT & ADVERTISING EXPENSE CAMs MAY BE THE ANSWER FOR DEALERS LOOKING FOR BIG, ONE-TIME TAX WRITE-OFFS. Another big topic discussed at the AICPA Dealership Conference in Orlando was the popularity of changes in accounting methods that dealers can now make to reduce inventory costs by Factory incentive payments, trade discounts and advertising charges.

The big attraction is that these method changes, like the initial adoption of LIFO, result in the largest part of the benefit being deductible in the year of change. Then, like LIFO, although continuous monitoring at subsequent years-end is required, the net changes are usually not too significant. And finally, like LIFO, it's really only a *timing difference.*

For the CPA or the controller trying to contend with all the detail alone, the work can be both tedious and overwhelming. Not only do year-end invoices for several years have to be analyzed, but other dealership information including floorplan and other reports must be reviewed in the course of making these determinations.

Incentive programs vary by manufacturer and, in some cases, by year. If the inventory is on LIFO, all prior year LIFO layers need to be recomputed. Since these changes cannot be made using the cut-off method, Section 481(a) adjustments are required.

What some CPAs and dealers may not be aware of is that, despite the underlying technicalities, *these overall changes in accounting methods can be made on a cost effective, turn-key basis.*

We have many dealer clients who are in the process of making these changes right now. We have been extremely busy in assisting them in this process. If you have any questions on this or if we can be of any assistance to you in this regard, please contact us immediately.

#6. AICPA NATIONAL AUTO DEALERSHIP CONFERENCE. This conference was held October 21-22, 2002 at Walt Disney's Contemporary Resort in Orlando. The conference included a number of sessions, some of which provided general industry information, while others provided specific tax and operations-related sessions.

As mentioned earlier, the two biggest tax issues discussed ... across several sessions ... related to what to do about Notice 2002-70 and the implications of making changes in accounting methods to reduce inventory costs to pull out Factory incentive payments and advertising charges.

IRS BROADENS ITS ATTACK ON TAX SHELTERS TO INCLUDE DEALER INSURANCE ACTIVITIES ... IRS NOTICE 2002-70 TREATS DEALER PORCs AS LISTED TRANSACTIONS

On October 15, 2002, the IRS released Notice 2002-70 as part of its broader overall assault on tax shelters. The seemingly egregious tax shelter activities and arrangements marketed by some of the larger accounting firms have been given considerable publicity in the financial press and various tax publications. In response, the Service has been coordinating a number of efforts directed at tax shelters that it doesn't like. (See *at a Glance*, page 6.)

Of more direct importance to readers of the *Dealer Tax Watch,* in Notice 2002-70 the Service stated that certain arrangements ***and substantially similar transactions*** would be considered as *listed transactions*. As a consequence, these arrangements would be subject to (1) disclosure requirements, (2) registration requirements and (3) list maintenance requirements.

At the AICPA Auto Dealership Conference in Orlando in October, discussion of Notice 2002-70 cast a pall over the proceedings. Copies of the text of Notice 2002-70 were passed out by Terri Harris, without comment, and Jim Smith, the speaker scheduled to present a regulatory update and discussion of new products and opportunities, conveyed his extreme concern over the position taken by the IRS in this matter. It should be noted that Terri Harris did state, at the Conference, that the IRS Notice really has no legal or judicial authority standing alone. It simply expresses the position of the IRS on this matter.

In the weeks since that Conference, Notice 2002-70 has generated significant controversy, action and reaction.

SOME REACTIONS

Advisor Andrew Weill, in his article, stated that "most automobile dealer-owned reinsurance companies do not fall within the scope of this Notice and the position of the IRS is internally inconsistent and ultimately cannot be sustained in enforcement proceedings."

Another advisor, F. Roy Sedore, has said, "It appears that, in Notice 2002-70, the Service may well have reached beyond those concerns, casting a net which may indiscriminately catch a number of legitimate transactions, without focusing on the truly egregious transactions."

Somewhat more subdued, Burgess J.W. Raby and William L. Raby conclude that "Notice 2002-70 serves as a caution to practitioners that the Service's tax shelter phobia can extend to captive insurance arrangements when it appears to the Service that the taxpayer is overreaching."

Last, but not least, Steve Mailho in his piece reproduced on pages 14-17 concludes that "The authors... obviously did not fully understand the complete business purpose, structure, ownership, pricing and premium flow for risks ceded to these allied reinsurance companies. When they do, they'll see the true face of allied reinsurance companies and they are ***not*** abusive tax shelters."

For citations to the articles referred to above, see the list of selected references.

CORPORATE STRUCTURING IS IMPORTANT

As far as the specific focus of Notice 2002-70 on dealer PORCs is concerned, it is important to note that the Service has addressed only arrangements where a ***wholly-owned parent-subsidiary*** relationship exists. It appears that the majority of dealer PORC arrangements are set up as brother-sister corporations owned by the dealer and/or other parties. Most PORCs are not set up as parent-subsidiary relationships.

But there's a fly in the ointment. It's the inclusion, without qualification, of similar or substantially similar transactions in the broad language of the regulations.

As pointed out by most commentators, there are multiple, undisputable (except, perhaps, to the IRS), valid business reasons for dealers to engage in the creation of PORCs. The most obvious reason is that PORCs assist dealers in improving (if not maintaining) higher levels of consumer satisfaction.

The following materials discuss the IRS' broader attack on tax shelters and the more specific focus of Notice 2002-70 on dealer PORCs. In addition, more detailed information on the tax return reporting requirements for listed transactions is included on pages 18-23. This is followed by our one-size-fits-all disclosure statement and by a Practice Guide (pages 26-27) with some of the factors for evaluating PORC exposure to attack by the IRS.

IRS vs. PORCs

SUGGESTED FURTHER REFERENCES

Notice 2002-70 ... IRS Attacks on Dealer PORCs

- Raby, Burgess J.W. and William L. Raby. *Captive Insurance - Some Lights in the Fog. Tax Notes.* Dec. 30, 2002, pgs. 1711-4.
- Sedore, F. Roy. *Notice 2002-70 and Tax-Exempt Insurers: Has the IRS Overstepped? Tax Notes.* Dec. 16, 2002, pgs. 1479-81.
- Weill, Andrew J. *Notice 2002-70: IRS Overreaction to a Nonexistent Problem. Tax Notes.* Dec. 16, 2002, pgs. 1473-8.

Sections 6011, 6111 & 6112 ... Analysis of Regulations & Reporting Requirements Consequences of Engaging in Listed Transactions

- Leeds, Mark H. *Focusing the Crosshairs: IRS Revises the Shelter Disclosure and Listing Rules. Tax Notes.* Nov. 18, 2002, pgs. 937-42.
- Lipton, Richard M. *New Tax Shelter Disclosure and Listing Regulations Promise Headaches for Everyone. The Journal of Taxation.* Jan. 2003, pgs. 5-21.
- Nijenhuis, Erika W., David H. Chung and Maxim S. Kulikov. *The New Disclosure and Listing Regulations for Tax Shelters. Tax Notes.* Nov. 18, 2002, pgs. 943-59.

PORCs & Insurance Company Status Issues ... In General

- De Filipps, Willard J. In the *Dealer Tax Watch.*
  - *Dealer Off-Shore Reinsurance Arrangements Get Some Favorable Guidance form Three Recently Published IRS Documents: LTR 199924001, FSA 1999-953 & ITA 199932007.* Sept. 1999, pg. 17.
  - *PORCs: More Attractive After TRA '97.* March 1998, pg. 16.
  - *Advances from Off-Shore PORC to Dealer Are Taxable Dividends - Wm. F. McCurley.* Sept. 1997, pg. 30.
  - *PORCs: Current Hot and Emerging Tax Issues.* Dec. 1996, pg. 9.
  - *Money on the Table ... A PORC Primer Resource.* March 1996, pg. 3.
- Raby, Burgess J.W. and William L. Raby. *Captive Insurance as a Sham Transaction. Tax Notes.* Sept. 4, 1995, pg. 1225.

At a Glance	IRS RECENT ACTIVITY AGAINST (ABUSIVE) TAX SHELTERS
General	• Most readers of the *Dealer Tax Watch* are zeroed in on Notice 2002-70 because it has the potential for most directly affecting their clients. However, it helps to understand that Notice 2002-70 is only one of several major initiatives recently undertaken by the IRS against tax shelters. • Tax shelters, of one sort or another, have been around for a long time. The Tax Reform Act of 1986 and the comprehensive revision of the Internal Revenue Code at that time bear this out. • More recently, a number of egregious practices have been publicized in the financial press which literally make the IRS appear out-gunned and out-matched in all respects. ♦ Various articles in the *New York Times* ♦ *Clients Sue E & Y and Three Law Firms Over Tax Shelter. Tax Notes*. December 30, 2002, pg. 1649. ... claiming that they "acted in concert to form an enterprise to 'sell phony tax strategies for millions or billions of dollars' in violation of RICO laws," (at page 1652).
Taxpayer Relief Act of 1997	• Three provisions significantly impact tax shelter activities • One provision treats corporate tax planning ideas offered in a confidential setting with "a significant purpose" of avoiding Federal income tax as "tax shelters." As such, these must be registered with the IRS if the promoters receive fees in excess of $100,000. • Any individual or corporate arrangement with "a significant purpose" of avoiding Federal income tax is treated as a "tax shelter" for purposes of the substantial underpayment penalty provisions. This means that taxpayers have to deal with more strict rules that apply to tax shelters in order to avoid these penalties. • For corporations participating in multi-party financing transactions, the substantial understatement penalty risk has been increased.
Code Sections Involved	• ***Section 6011*** ... Requires taxpayers to make various disclosures on their income tax returns where they have been involved in transactions that have characteristics common to tax shelters. ♦ Related IRS form for pre-2003 transactions ... ***Form 8886*** - Not yet issued. • *Section 6111* ... Requires the promoters of a tax shelter to register that tax shelter prior to the sale of interests in that entity. ♦ Related IRS form ... *Form 8271 - **Investor Reporting of Tax Shelter Registration Number*** • *Section 6112* ... Requires the promoters of tax shelters to maintain lists of certain transactions, which include, but are not limited to, transactions that must be registered. • ***Penalties for non-compliance*** ... See Sections 6707, 6708, 6662, 6694, 6700 and 6701.
February 2000 ***Initial IRS Regulations*** ***For Pre-2003 Transactions***	• IRS issued detailed Regulations affecting taxpayers involved in "listed transactions." These Regulations addressed ♦ Disclosure requirements under Section 6011 ♦ Registration requirements ♦ List maintenance requirements under Section 6112 • These Regulations have been amended several times • Originally, the disclosure Regulations did not apply to individual taxpayers and there were no penalties imposed for failure to disclose.
Treasury Announces Plan to Combat Abusive Tax Avoidance Programs ***March 20, 2002***	• Accompanied by statements from Treasury Secretary O'Neill, Commissioner Rossotti and Mark Weinberger, the Office of Public Affairs in PO 2018 released the details of certain major initiatives. • Treasury proposals to curb abusive transactions ♦ The Abusive Tax Avoidance Transaction Problem: Symptom of a Larger Problem. ♦ The Importance of Transparency and Vigorous Enforcement. ♦ New Broader Disclosure Requirements and Enhanced Penalties Needed. • Accompanied by Treasury's legislative proposals and administrative actions.

At a Glance	IRS RECENT ACTIVITY AGAINST (ABUSIVE) TAX SHELTERS
Notice 2002-70 *October 15, 2002*	• Included among various IRS listings of suspect transactions were "transactions involving the use of captive insurance companies designed to take advantage of preferential tax treatment accorded to insurance companies ***without taking on the insurance risk***." • In Notice 2002-70 (2002-44 IRB 765, October 15, 2002), the IRS addressed certain transactions that usually involve a ... automobile dealer ... that offers its customers an insurance contract in connection with the products being sold, where the insurance covers repairs or replacement costs if the product breaks down, is lost, stolen or damaged. • These are the dealer PORCs, and this is the Notice that generated so much discussion at the AICPA National Auto Dealership Conference in Orlando only a week or so after Notice 2002-70 was issued. • See *At a Glance ... Dealer PORCs* ... pages 8-9.
Revised IRS Regulations For Post-2002 Transactions *October 22, 2002*	• These Regulations became effective January 1, 2003. • Expanded list maintenance requirements that apply to anyone who is a ***material advisor*** with respect to a potentially abusive tax shelter. • Contain disclosure, registration and list maintenance requirements • These revised Regulations will impose a "price that all practitioners have to pay as a result of the egregious activities of a few practitioners who have been actively marketing abusive tax shelters." (Lipton, *J. Tax*, Jan. 2003, p. 5) • It is clearly possible that the list maintenance requirements may have unexpected application, because all fees - not just fees related to tax advice - must be taken into account in determining whether minimum fee thresholds have been satisfied. • Many other routine transactions could be treated as "potentially abusive tax shelters" because of the broad scope of reportable transactions. This is particularly possible for transactions that generate significant book-tax differences. (Lipton, *J. Tax*, Jan. 2003, p. 19)
Other Related IRS Actions Affecting Other Specific Transactions *Late 2002*	• Treasury is successful in obtaining tax information exchange agreements with offshore financial centers. These agreements allow IRS to pursue information on civil and criminal tax evaders even when countries have bank secrecy laws. • ***Pass-through entity (foreign currency) straddles*** ... Notice 2002-65 • ***Section 351 contingent liability transactions*** ... Revenue Procedure 2002-67 • ***COLI (leveraged corporate-owned life insurance) plans*** ... Announcement 2002-96 • ***Basis-shifting transactions*** ... Announcement 2002-97 • ***LILO (Lease-in/Lease-out) transactions*** ... Rev. Rul. 2002-69 • ***Tax shelters involving purported insurance companies*** ... Notice 2002-70 above
IRS Settlement Offers	• Hopelessly out-manned and out-maneuvered on many of the above, the IRS is reported to be considering special deal settlement offers to entice participants in questionable transactions to come forward by amending their tax returns. • If taxpayers voluntarily come forward, the IRS may not assert fraud penalties, but will obviously collect deficiencies plus interest. The status of potential imposition of other penalties (such as accuracy-related penalties) is presently unclear.
IRS Sues Major Accounting Firms	• In order to learn the identity of participants in tax shelters promoted by large accounting firms, the IRS has been successful in suing them for the release of their document-specific privilege logs and other information previously thought to be privileged or confidential. • *U.S. vs. KPMG, LLP*, No. 02-0295 (D.D.C. Dec. 20, 2002) Federal District Court for the District of Columbia. • Section 7525 does not afford tax advisors any greater degree of protection or privilege for tax advice. Most tax advice falls into the category of return preparation, for which there is no privilege. • See *No Privilege for Tax Planning* by Lee A. Sheppard in *Tax Notes*, January 13, 2003, pg. 159.
Clients Sue Major Accounting Firms	• Clients of Ernst & Young have sued the firm to prevent disclosure of their names to the IRS. • Suit was dropped when IRS learned identity of taxpayers through other means. • Will there be other suits?

Notice 2002-70	ARE PORCs ABOUT TO BE SLAUGHTERED? NOTICE 2002-70 UPSETS DEALERS & THEIR ADVISORS
What Are PORCs? *Why Are PORCs Around?*	• PORC stands for Producer Owned Reinsurance Company. • Through their normal operations, automobile dealerships sell products which have the potential to generate substantial insurance premium income. • Dealers are constantly approached by service providers offering to set up and maintain for them insurance/reinsurance arrangements. These arrangements vary widely depending on the promoters' experience, preferences and familiarity with (off-shore) domicile regulatory climates. • The attraction in setting up a PORC is that it should allow the dealer to maximize his income from his/her involvement with insurance activities. PORC proposals typically show a dealer that he or she can expect greater underwriting profits, investment income and potential tax benefits, not to mention the usual "estate planning" and/or income shifting opportunities available through more diverse ownership of the PORC. • Different regulatory requirements result in different capitalization requirements. • Different tax benefits are available to PORCs under different Sections of the Code.
Why the Fuss Over PORCs Right Now?	• First of all, blatant abuses of many types have been getting a lot of publicity lately. • As far as PORCs go, some dealers may be involved with programs where less-regulated domiciles (foreign countries) are concerned. Also, some may be claiming to be completely exempt from tax under Sec. 501(c)(15). • It is possible that in an effort to challenge these "more daring" situations, certain elements within the IRS were successful in lobbying for the inclusion of very broad language in Notice 2002-70.
What Does Notice 2002-70 Say?	• Essentially, the Notice says that the IRS is (going to be) looking at dealer PORCs, along with a lot of other insurance/reinsurance arrangements it suspects may be abusive. • The Service has several possible attacks available, depending on the nature of the taxpayer's arrangement. • PORC transactions are considered by the IRS to be listed or reportable transactions. • The Notice is very broad and lumps together all insurance/reinsurance arrangements. • No safe-harbor arrangements are identified; everything is under suspicion.
Three Possible IRS Challenges to PORCs	• ***First, depending upon the facts and circumstances, the Service may assert that the taxpayer is not an insurance company for federal income tax purposes.*** ♦ ***Whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year.*** ♦ ***Factors to be considered include ... the size and activities of any staff, whether the taxpayer engages in other trades or businesses, and its sources of income.*** • ***Second, the IRS may apply Sections 482 or 845 to reallocate income between the related entities if that reallocation is necessary to clearly reflect the income.*** • ***Third, the Service may take the position that the arrangements are shams in fact or shams in substance. In these scenarios, the IRS will disregard the insurance and reinsurance arrangements, and require the taxpayer to recognize an additional portion of premiums received from its customers as its income.***
What Is a "Notice?"	• A Notice has no legal standing. It has no precedential value. • A Notice simply informs taxpayers of the Service's intentions or thoughts/attitudes about the subject.
Reporting Requirements	• Extremely complex, overlapping and broadly written to include requirements for reporting transactions that are "substantially similar" to those specifically identified. • Different rules (i.e., Regulations) apply to ♦ Transactions on or before December 31, 2002 ♦ Transactions on or after January 1, 2003 • See pages 18-26 for more information.

Notice 2002-70	ARE PORCs ABOUT TO BE SLAUGHTERED? NOTICE 2002-70 UPSETS DEALERS & THEIR ADVISORS
Dilemma for CPAs Preparing Tax Returns	• If PORC "transactions" are listed or reportable transactions, disclosures of that involvement are required to be included in Federal income tax returns filed by ***all*** participants. ♦ Dealer's personal return ... Form 1040 ♦ Dealership (corporate) return ... Forms 1120, 1120S, or other entity forms ♦ PORC ... various corporate forms • In many instances, the tax return for the PORC is prepared by the promoter, not by the dealer's CPA. • Different disclosure requirements apply to pre-2003 and post-2002 transactions • No IRS forms have been issued yet. Form 8886 only applies to reporting post-2002 transactions. • Disclosures for participation in prior years may be required and may result in amended tax returns. • Possibility of including a ***protective*** disclosure statement.
Factors Possibly Limiting the Application of Notice 2002-70	• The Notice specifically addresses only wholly-owned parent-subsidiary corporate relationships. • The majority of PORC arrangements involve brother-sister corporate relationships. • Dealers claim that using a separate entity/PORC results in much higher levels of Customer Satisfaction, improved CSI scores, etc. This would seem to be one of the dominant business reasons for justifying the existence of a PORC. • One industry advisory group has been formed to work with the IRS to clarify the reach of Notice 2002-70. (Possible retraction or modification of Notice 2002-70.)
Reactions & Consensus	• Properly structured and properly implemented, PORCs should pass muster. • The IRS has been successful in challenging some arrangements in the Tax Court. Taxpayers need to be able to distinguish their facts and circumstances from those successfully challenged by the IRS, including ♦ *Malone & Hyde vs. Commissioner* ♦ *William Wright vs. Commissioner* ♦ *William L. McCurley vs. Commissioner* • Although these three cases are mentioned by the IRS all the time (i.e., saber-rattling), they really have little applicability in situations where the insurance/reinsurance arrangements are properly structured. • Idea is that it is not the dealers who are under attack. Realistically, it may be the promoters who are under attack if they have set up egregious front companies with "illusionary reinsurance" and/or "risk transfer." • See *Checklist for Evaluating PORC Exposure to IRS Attack* ... pages 26-27.
Clarification with Recent IRS Rulings Needed	• ***Revenue Ruling 2001-31*** ... In this Revenue Ruling, the IRS indicated that it would accept brother-sister corporate family groups. In other words, the Service dropped its more usual challenge to the deductibility of premiums paid where those premiums were paid to another member of an "economic family" to which the payer belonged. (2001-1 C.B. 1348) • ***Revenue Ruling 2002-89*** ... This Revenue Ruling outlined two situations to illustrate what circumstances must exist between a parent and a subsidiary insurance company in order for the insurance premiums paid by the parent to the subsidiary to be deductible as "insurance premiums" under Section 162. (2002-52 I.R.B. 1) • ***Revenue Ruling 2002-90*** ... In this Revenue Ruling, the Service held that insurance premiums paid by the 12 domestic operating subsidiaries to another wholly-owned insurance subsidiary (formed for valid non-tax business purposes) were deductible as "insurance premiums" under Section 162. (2002-52 I.R.B. 1)
Citation	• IRS Notice 2002-70. 2002-44 I.R.B. 765

IRS NOTICE 2002-70
CERTAIN REINSURANCE ARRANGEMENTS

PURPOSE & DESCRIPTION OF ARRANGEMENTS AT ISSUE

The Internal Revenue Service and Treasury Department have become aware of a type of transaction, described below, that is being used by taxpayers to shift income from taxpayers to related companies purported to be insurance companies that are subject to little or no U.S. federal income tax. This notice alerts taxpayers and their representatives that these transactions often do not generate the federal tax benefits that taxpayers claim are allowable for federal income tax purposes. This notice also alerts taxpayers, their representatives, and promoters of these transactions, to certain reporting and record keeping obligations and penalties that they may be subject to with respect to these transactions.

The transaction generally involves a taxpayer ("Taxpayer") (typically a service provider, ***automobile dealer***, lender, or retailer) that offers its customers the opportunity to purchase an insurance contract through Taxpayer in connection with the products or services being sold. The insurance provides coverage for repair or replacement costs if the product breaks down or is lost, stolen, or damaged, or coverage for the customer's payment obligations in case the customer dies, or becomes disabled or unemployed.

Taxpayer offers the insurance to its customers by acting as an insurance agent for an unrelated insurance company ("Company X"). Taxpayer receives a sales commission from Company X equal to a percentage of the premiums paid by Taxpayer's customers. Taxpayer forms a wholly-owned corporation ("Company Y"), typically in a foreign country, to reinsure the policies sold by Taxpayer.

Promoters sometimes refer to these companies as producer owned reinsurance companies or "PORCs".

If Company Y is a foreign corporation, it typically elects to be treated as a domestic insurance company under Section 953(d) of the Internal Revenue Code. Company Y takes the position that it is entitled to the benefits of Section 501(c)(15) (providing that non-life insurance companies are tax exempt if premiums written for the taxable year do not exceed $350,000), Section 806 (providing a deduction for certain life insurance companies with life insurance company taxable income not in excess of $15,000,000), or Section 831(b) (allowing qualifying non-life insurance companies whose net written premiums are between $350,000 and $1,200,000 to elect to be taxed solely on investment income).

Taxpayer receives premiums from its customers and remits those premiums (typically net of its sales commission) to Company X. Company X pays any claims and state premium taxes due and retains an amount from the premiums received from Taxpayer. Under Company Y's reinsurance agreement with Company X, Company Y reinsures all insurance policies that Taxpayer sells to its customers. Company X transfers the remainder of the premiums to Company Y as reinsurance premiums.

Many of the transactions described in this Notice have been designed to use a reinsurance arrangement to divert income properly attributable to Taxpayer to Company Y, Taxpayer's wholly- owned reinsurance company that is subject to little or no federal income tax. The Service intends to challenge the purported tax benefits from these transactions on a number of grounds.

FIRST IRS ATTACK

First, depending upon the facts and circumstances, the Service may assert that Company Y is not an insurance company for federal income tax purposes. For federal income tax purposes, an insurance company is a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 1.801-3(a) of the Income Tax Regulations; Section 816(a) (which provides that a company will be treated as an insurance company for federal income tax purposes 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 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). ***To determine whether Company Y qualifies as an insurance company, all of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether Company Y 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).

(The Service may argue that) if the taxpayer (Company Y) is not an insurance company, it is not entitled to the benefits of Sections 501(c)(15), 806, or 831(b). Further, if Company Y is a foreign corporation and is not an insurance company, any election Company Y made under Section 953(d) is not valid and Company Y will be treated as a controlled foreign corporation as defined in Section 957. In such a case, Taxpayer will be treated as a U.S. shareholder of Company Y and generally will include in its gross income on a current basis any subpart F income of Company Y. See Section 951(a) and (b). In addition, Company Y will not qualify for the exceptions from subpart F income under Sections 953(a)(2) and 954(i) for certain insurance income because those exceptions are only available to a foreign corporation that, among other requirements, is engaged in the insurance business and would be subject to tax under subchapter L if such corporation were a domestic corporation. See Section 953(e)(3)(C).

SECOND IRS ATTACK ... REALLOCATION OF INCOME

Second, the Service may apply Sections 482 or 845 to allocate income from Company Y to Taxpayer if necessary clearly to reflect the income of Taxpayer and Company Y. Section 482 provides the Secretary with authority to allocate gross income, deductions, credits or allowances among persons owned or controlled directly or indirectly by the same interests, if such allocation is necessary to prevent evasion of taxes or clearly to reflect income. The Section 482 regulations provide that in determining the taxable income of a controlled person, the standard to be applied is that of a person dealing at arm's length with an uncontrolled person. Section 1.482- 1(b)(1). Section 482 may apply to a transaction between two or more controlled persons notwithstanding that an uncontrolled person participates in the transaction as an intermediary. See *GAC Produce Co. v. Commissioner*, T.C.M. 1999-134. If, as a result of the reinsurance transaction, Taxpayer's income is not consistent with the arm's length standard, then Section 482 authorizes the Secretary to allocate income from Company Y to Taxpayer. Section 845(a) allows the Service to reallocate income, deductions, assets, reserves, credits, and other items between two or more related parties who are parties to a reinsurance agreement. Thus, such items may be reallocated from Company Y to Taxpayer under the authority of Section 845(a).

THIRD IRS ATTACK ... SHAMS "IN FACT" OR "IN SUBSTANCE"

Third, in appropriate cases, the Service may disregard the insurance and reinsurance arrangements, and thereby require Taxpayer to recognize an additional portion of premiums received from its customers as its income, if the arrangements are shams in fact or shams in substance. See *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989). Courts have distinguished between "shams in fact" where the reported transactions never occurred and "shams in substance" which actually occurred but lack the substance their form represents. *ACM Partnership v. Commissioner*, 157 F.3d 231, 247 n. 30 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (2002) (citations omitted).

In determining whether a transaction constitutes a sham in substance, both a majority of the Courts of Appeals and the Tax Court consider two related factors, economic substance apart from tax consequences, and business purpose. See *ACM Partnership; Karr v. Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991), *cert. denied*, 502 U.S. 1082 (1992); *James v. Commissioner*, 899 F.2d 905, 908-09 (10th Cir. 1990); *Shriver v. Commissioner*, 899 F.2d 724, 727 (8th Cir. 1990); *Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989); *Kirchman*.

Although a taxpayer has the right to arrange its affairs to reduce its tax liability, the substance of a transaction must govern its tax consequences regardless of the form in which the transaction is cast. See *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). If the transactions involving Taxpayer, Company X, and Company Y are disregarded, the income of Company Y is income of Taxpayer. See *Wright v. Commissioner*, T.C.M. 1993-328.

CONSEQUENCES OF ENGAGING IN QUESTIONABLE ARRANGEMENTS ... "LISTED TRANSACTION" STATUS

Transactions that are the same as, or substantially similar to, the transaction described in this Notice that involve taxpayers claiming entitlement to the benefits of Sections 501(c)(15), 806, or 831(b) are identified as "listed transactions" for purposes of Section 1.6011-4T(b)(2) of the temporary Income Tax Regulations and Section 301.6111-2T(b)(2) of the temporary Procedure and Administration Regulations. See also Section 301.6112-1T, A-4.

Independent of their classification as "listed transactions" for purposes of Sections 1.6011-4T(b)(2) and 301.6111-2T(b)(2), transactions that are the same as, or substantially similar to, ***the transactions described in this notice may already be subject to the disclosure requirements*** of Section 6011, the tax shelter registration requirements of Section 6111, ***or the list maintenance requirements*** of Section 6112 (Sections 1.6011-4T, 301.6111-1T, 301.6111-2T and 301.6112-1T, A-3 and A-4).

PENALTIES ... NO LESS THAN 5 SEPARATE PENALTIES COULD APPLY

Persons who are required to satisfy the registration requirement of Section 6111 with respect to the transactions described in this Notice and who fail to do so may be subject to the penalty under Section 6707(a). Persons who are required to satisfy the list-keeping requirement of Section 6112 with respect to the transactions described in this notice and who fail to do so may be subject to the penalty under Section 6708(a).

In addition, the Service may impose penalties on participants in these transactions or substantially similar transactions involving taxpayers claiming entitlement to the benefits of Sections 501(c)(15), 806, or 831(b) or, as applicable, on persons who participate in the promotion or reporting of such transactions, including the accuracy-related penalty under Section 6662, the return preparer penalty under Section 6694, the promoter penalty under Section 6700, and the aiding and abetting penalty under Section 6701.

AUTHORS OF NOTICE

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Citation: Notice 2002-70; 2002-44 IRB (October 15, 2002)
Note: Captions and emphasis added.

Producer Owned Reinsurance Companies

- Notice 2002-70 Issued October 15, 2002
  - Transactions designed to use a reinsurance arrangement to divert income to companies subject to little or no tax.
    - Notice alerts taxpayers that transactions often do not generate the tax benefits that taxpayers believe are allowable
    - Alerts taxpayers, representatives, and promoters of certain reporting and record-keeping requirements

Producer Owned Reinsurance Companies

- Notice applies to:
  - Service providers
  - Automobile Dealers
  - Lenders
  - Retailers
    - That offer customers the opportunity to purchase an insurance contract in connection with products being sold

Producer Owned Reinsurance Companies

- For example: Insurance provides coverage for
  - Repair or replacement upon breakdown, loss, theft, or damage
  - Coverage for customer's payment obligations upon death, disability, unemployment
    - Related company reinsuring the risk (PORC)
      - Elects 953(d) treatment
      - Insurance company benefits
      - Tax exempt status – 501(c)(15)

Producer Owned Reinsurance Companies

- How does this affect an auto dealership?
  - Dealers that sell products, insure certain risks and reinsure the risk with a PORC
    - Extended Service Contracts
      - Dealer Obligor
      - Administrator or Other Obligor
    - Credit Life and Disability Insurance

Producer Owned Reinsurance Companies

- Conclusions depend on facts and circumstances
  - PORC is not an insurance company
    - §§ 501(c)(15) (tax exempt status), 806 (life insurance company), 631(b) (non-life companies) <u>do not apply</u>
    - Company is a foreign corporation and §953(d) election is invalid
  - §§ 845 or 482 may be applied to allocate income to the taxpayer that earned it
  - Insurance and reinsurance agreements will be disregarded and require recognition of additional income by the taxpayer

Producer Owned Reinsurance Companies

- Mechanics of Notice 2002-70
  - §6011 – Taxpayers must disclose participation in reportable transactions
    - Corporations, Partnerships, Trusts, S Corporations, Individuals
      - Attach a written statement to each tax return affected
      - First Year – provide copy to Office of Tax Shelter Analysis

Producer Owned Reinsurance Companies

- Mechanics of Notice 2002-70
  - §6011 – Taxpayers must disclose participation in reportable transactions
    - Corporations, Partnerships, Trusts, S Corporations, Individuals
      - Direct or Indirect participation
      - Attach a written statement to each tax return affected

Producer Owned Reinsurance Companies

- No specific form – Regulation 1.6011-4T provides information to include
  - Brief Description of Transaction
    - Including taxpayer's manner of participation
  - Identification of each taxable year
    - Including prior years
  - An estimate of the amount by which the transaction is expected to reduce tax liability

Producer Owned Reinsurance Companies

- § 6111 – Promoter, organizers, sellers, managers must register transactions with IRS
- § 6112 – Requires organizers and sellers to maintain lists of investors
  - Provide to IRS upon request

Producer Owned Reinsurance Companies

- Notice not intended to cover all possible situations
  - Transactions that are <u>substantially the same as or similar</u> to the notice identified as "listed transactions"
    - §1.6011-4T and §301.6111-2T(b)(2)
  - May already be subject to disclosure and tax shelter registration requirements of §§6011 and 6111
    - Additional guidance may follow
      - Soliciting Questions for Our Consideration and Further Guidance

ANALYSIS OF NOTICE 2002-70
BY PORC INDUSTRY INSIDER, JOHN S. MAILHO*

BACKGROUND, UPDATE & CONCLUSIONS ABOUT ABUSIVE TAX SHELTERS

BACKGROUND

The IRS gives three alternative theories that dealership allied reinsurance companies are not insurance companies at all but instead, abusive tax shelters:

1. The reinsurance company's primary and predominant business is not that of insurance; the business is self insurance and the result is that the company is of a "captive" variety not worthy of insurance company tax treatment
2. The reinsurance company is an investment fund masquerading as an insurance company
3. Insurance premiums are priced arbitrarily in collusion with the parent automobile dealership, designed to shift income into preferential tax environments

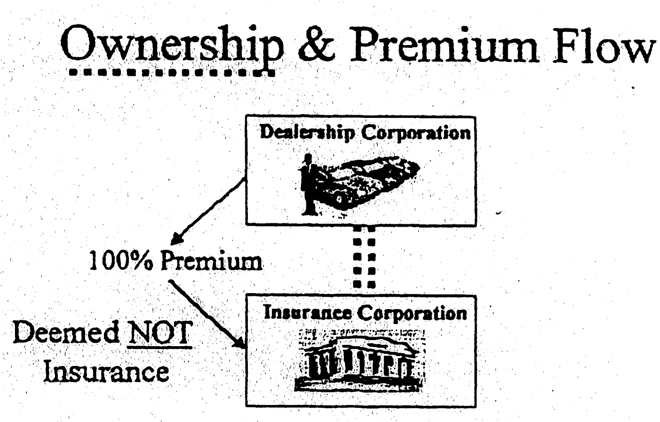
Based on these IRS perceived facts, they conclude that these reinsurance companies are abusive tax shelters.

IRS Myth #1

Attempting to justify their position, the Notice outlines ownership of the reinsurance company and premium flow to the reinsurance company.

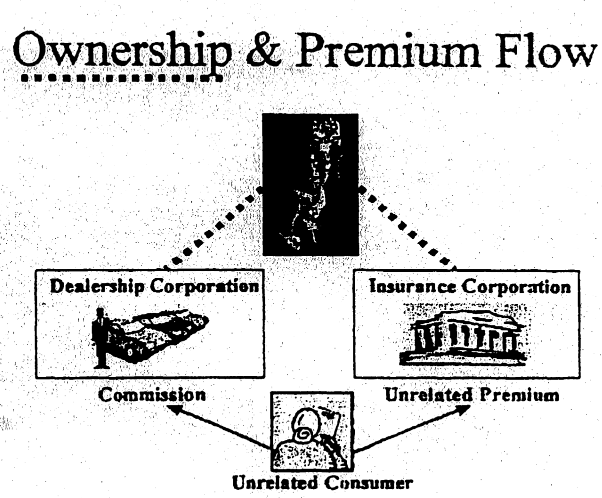
In concluding that this is not insurance, the IRS makes two broad assumptions: (1) the insurance company is a subsidiary to the dealership making it related as "parent-child" and, (2) the risk is self-insurance

Their conclusion is that this is not insurance at all, not deserving to be treated as an insurance company for tax purposes. And since it is not insurance it can only be an abusive tax shelter.



Correct Facts

1. In many cases, an individual owns both the dealership and the insurance company. Thus these two corporations are considered siblings or, "brother-sister". There are also business reasons when individuals with no ownership interest in the dealership, own these reinsurance companies.
2. The risk is not that of the dealership but that of the consumer. Therefore 100% of the risk is third party and unrelated to the dealership. The dealership acts as a fiduciary for the insurance company and collects premium (including it's own commission) from the consumer. This is much the same as Debit Insurance Agents collecting premium directly from the insureds.



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3650 White Alder, Sonoma, CA 95476 (707) 996-6321 or (800) 262-4546 JSMailho@ReinsuranceNet.com

IRS Myth #2

The Announcement concludes that the reinsurance company is an investment fund masquerading as an insurance vehicle and receiving preferential tax treatment. The IRS took great pains to outline several tax cases where investment income was far above the premium generated for the reinsurance company.

The genesis of their reasoning was the cover page and feature article in ***Forbes Magazine*** (5th of March 2001) where hundreds of millions of dollars in investment earnings were being sheltered from tax in a tiny insurance company. The author spoke of this as a "tax goodie" from the code. This transaction showed $3,300 in Premium and one hundred seventy-nine million ($179,000,000) dollars of earnings on investments, a whopping 54,000% differential! The article went on to slap the IRS' face for not catching this obvious abuse.

Searching around for a handy target, the IRS found that most small insurance companies are somehow allied with automobile dealership activities; thus the bias toward what they consider an easy target - automobile dealers.

Correct Fact

This chart shows data from thousands of tax returns prepared for automobile dealer allied reinsurance companies. On nearly one billion dollars of premium, the investment income generated is a mere eight (8%) percent differential.

Actual Tax Returns			
Tax Year	Premium	Interest	% Interest
1995	69,882,091	5,956,013	8.5%
1996	86,261,910	6,456,268	7.5%
1997	106,321,357	8,805,044	8.3%
1998	121,671,174	10,805,105	8.9%
1999	146,839,774	11,273,948	7.7%
2000	163,329,276	13,717,436	8.4%
2001	207,411,826	13,815,335	6.7%
TOTAL	***901,717,408***	***70,829,149***	***7.9%***

It is obvious, even to the most cynical observer, that IRS targeting of dealer allied reinsurance companies is truly a myth. If these companies are masquerading as investment vehicles they are not doing a very good job!

IRS Myth #3

The premiums charged to the dealership by the insurance company are arbitrarily priced. These "transfer pricing" distortions cause income, normally that of the dealership, to be shifted to the insurance company in a preferential tax environment. Therefore it is an abusive tax shelter.

Correct Facts

This last myth compounds the first myth. It assumes that the risk is that of the dealership – it is not. Rather, the risk is that of the consumer. (S)he makes an independent economic decision to relieve the family of the risk of loss – the convincing evidence is that this consumer must agree to, and actually pays an identifiable and specified premium for this coverage. This premium is collected by the dealership.

Furthermore the premiums for the risk are not arbitrarily established by the dealership but rather by

1. The Department of Insurance, and
2. The third-party unrelated direct writing insurance company.

The Department of Insurance examines premium charges and on many products require pre-approval of the rates. Some product lines have guidelines established by the Department of Insurance where a set-premium is established statewide.

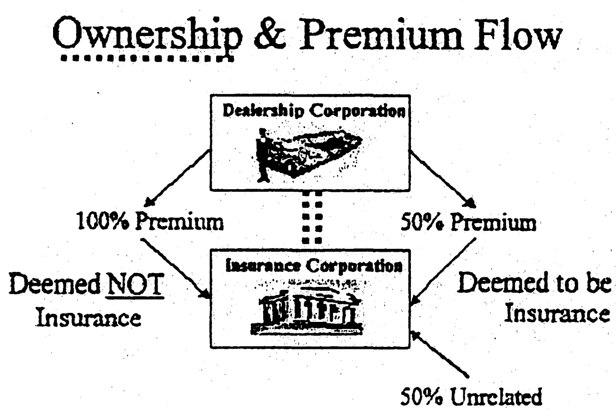
UPDATE

A major development occurred giving bright line guidance to IRS positioning. This new development clearly shows that these reinsurance companies are not in the classification of abusive tax shelters. We must presume the IRS is speaking with one voice.

Two months after the IRS abusive tax shelter position was announced, two companion Revenue Rulings were published. Both concerned self-insurance (a/k/a captive) risks, and while "captive" is not the case with dealer allied reinsurance companies, they give guidance to the structure of arrangements. We will call these Parent-Child and Brother-Sister structures.

Parent-Child

In *Rev.Rul. 2002-89* the IRS provided guidance on whether arrangements between a parent corporation and its insurance subsidiary qualified as insurance for tax purposes. There were two fact scenarios resulting in two different conclusions for tax purposes.

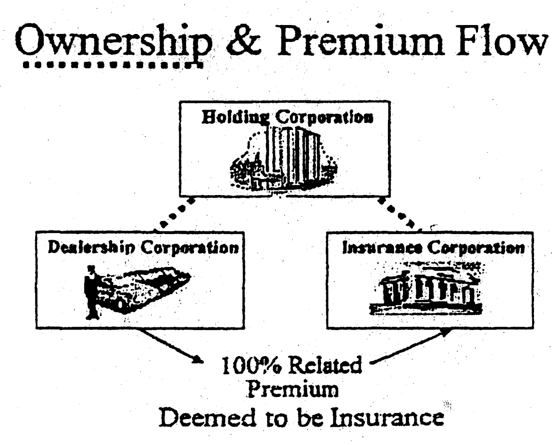


Fact Scenario #1 – one hundred (100%) percent of the insurance subsidiary's risk was derived from the parent corporation. This was deemed NOT to be insurance

Fact Scenario #2 – fifty (50%) percent of the insurance subsidiary's risk was derived from the parent corporation. The remaining was unrelated to the parent. This was deemed to be insurance. Tax Case law supports this percentage to be as low as 30% unrelated in order to make the transaction insurance for tax purposes.

Brother-Sister

In *Rev.Rul. 2002-90* the IRS ruled that premiums paid by operating subsidiaries to a captive insurance company owned by a common parent corporation are deductible as insurance premiums.



The fact scenario of an allied reinsurance company more closely resembles this Brother-Sister structure than the parent-child structure in its companion Revenue Ruling.

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CONCLUSION

The authors of Announcement 2002-70 obviously did not fully understand the complete business purpose, structure, ownership, pricing and premium flow for risks ceded to these allied reinsurance companies. When they do, they'll see the TRUE FACE OF ALLIED REINSURANCE COMPANIES and they are NOT abusive tax shelters.

Self Insurance

It is not self-insurance therefore the negative tax implications of "captives" will not apply. In arguendo (as our friends from the legal profession would say), if somehow this is deemed to be self-insurance - tax cases, IRS authored Field Service Advices, Private Letter Rulings and Revenue Rulings show us that the allied reinsurance company structure (Brother-Sister) is insurance for tax purposes.

A fact further divorcing allied reinsurance companies from the strict brother-sister interpretation approved by the IRS is that individuals, not corporations, own the insurance company. This falls in direct parallel to the case of United Parcel Service of America Inc., et al. v. Commissioner.

One more fact divorces these even further – there is often dispirit ownership in the dealership corporation and the allied reinsurance company. That is to say, a reinsurance company owner may only own a portion, if any part, of the dealership.

Disguised investment mechanism

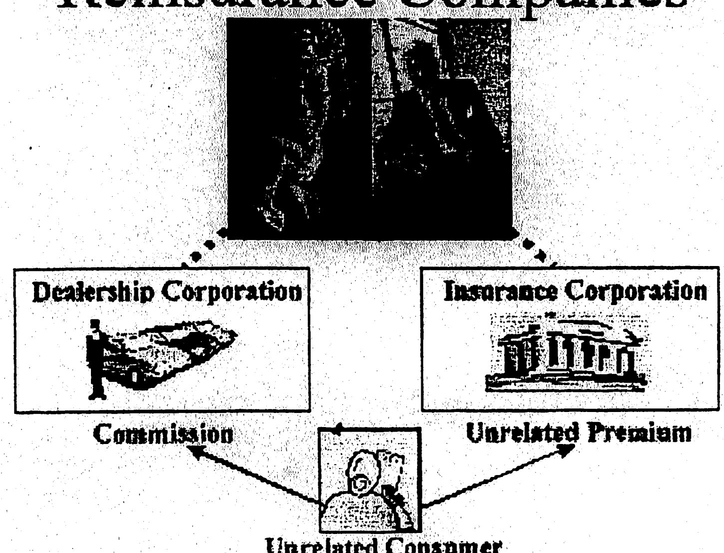
As evidenced by hard facts (nearly 1 Billion dollars in premium recorded in thousands of tax returns), this could hardly be called an investment mechanism or scheme.

Self-Dealing

Insinuating that less than arms length pricing exists between the dealerships and the insurance entity is off-target. First, the risk is not that of the dealership – it is that of the consumer. Second, third parties (Departments of Insurance and Direct Writing Insurance companies) establish rates they deem appropriate for the protection of the consumer.

These most recent bright line Revenue Rulings guide and give comfort that these reinsurance companies are not abusive tax shelter schemes.

The True Face of Allied Reinsurance Companies



Temp. Reg. Sec. 6011-4T	**REQUIREMENTS FOR INCLUDING STATEMENTS IN INCOME TAX RETURNS DISCLOSING PARTICIPATION IN CERTAIN TRANSACTIONS**	
Application	***Transactions Entered Into Before January 1, 2003 (i.e., Dec. 31, 2002 and Prior)***	***Transactions Entered Into On or After January 1, 2003 (i.e., After Dec. 31, 2002)***
Overview	♦ General outline of Regulations appears below. ♦ Regulations are extremely complex, profuse with exceptions and effective date limits. ♦ The requirements for including statements in tax returns disclosing participation in certain transactions are found in Reg. Sec. 6011-4T. ♦ There are separate requirements related to • Registration of tax shelters ... Section 6111 and Regulations thereunder. • The maintenance of lists by promoters of investors in their tax shelters ... Section 6112 "Organizers and Sellers of Potentially Abusive Tax Shelters Must Keep Lists of Investors	♦ Regulations are extremely complex. ♦ Outline of Regulations appears below, with certain general comments. ♦ Somewhat simplifies overall structure. ♦ Coordinates the rules for disclosure and list maintenance by applying such rules to the same transactions. In other words, a transaction that is subject to disclosure will also be subject to the list maintenance requirements if the material advisor receives fees over a stated threshold. ♦ Disclosure and list maintenance is required only with respect to six types of transactions (see below). ♦ All of the exceptions that previously applied to disclosure and list maintenance have been eliminated. Now, if a transaction satisfies any one of the six tests, then disclosure and list maintenance are both required. ♦ The definition of ***"promoter"*** has been changed by applying the requirement for list maintenance to any person who provides any tax advice in connection with a transaction and who receives a fee above certain specified thresholds. ♦ For a comprehensive analysis, see *New Tax Shelter Disclosure and Listing Regulations Promise Headaches for Everyone* by Richard Lipton. *The Journal of Taxation*. Jan. 2003, pgs. 5-21.
Disclosure Requirement ***6011-4T(a)***	♦ ***(1) In general.*** ♦ ***(2) Example of indirect participation.*** ♦ ***(3) Definition of taxpayer.***	♦ Every taxpayer that has participated, directly or indirectly, in a reportable transaction ... must attach to its tax return for the taxable year, described in paragraph (e) [*Time of Providing Disclosure*], a disclosure statement in the form prescribed by paragraph (d) of this Section. ♦ The term *taxpayer* includes individual taxpayers. ♦ The fact that a transaction is a reportable transaction shall not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.
Reportable Transactions ***6011-4T(b)***	♦ ***(1) In general.*** ♦ ***(2) Listed transactions.*** ♦ ***(3) Other reportable transactions.*** ♦ ***(4) Projected tax effect.*** ♦ ***(5) Examples.***	♦ ***In general***, there are six categories of reportable transactions 1. ***Listed transactions*** ... Any transaction that is the same as or substantially similar to tax avoidance transactions identified by the IRS. 2. ***Confidential transactions*** ... Any transaction offered under conditions of confidentiality. 3. ***Transactions with contractual protection*** ... Any transaction for which the corporation has contractual protection against disallowance of the tax benefits. 4. ***Loss transactions*** ... Any transaction resulting in a loss of at least \$10 million in any single year or \$20 million in any combination of years. 5. ***Transactions with a significant book-tax difference*** ... Any transaction resulting in a book-tax difference of more than \$10 million on a gross basis. *(Continued)*

Temp. Reg. Sec. 6011-4T	*REQUIREMENTS FOR INCLUDING STATEMENTS IN INCOME TAX RETURNS DISCLOSING PARTICIPATION IN CERTAIN TRANSACTIONS*	
Reportable Transactions ***6011-4T(b)*** (Continued)		6. ***Transactions involving a brief asset holding period*** ... any transaction resulting in a tax credit of more than $250,000, if the corporation held the asset generating the credit for less than 45 days. ♦ The term "transaction" includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan or arrangement and includes any series of steps carried out as part of a plan, and any series of substantially similar transactions entered into in the same taxable year. ♦ ***Definition of listed transaction ...*** (is) any transaction that is the same as, or substantially similar to, a listed transaction is a *reportable* transaction. A "substantially similar transaction" is any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy." (Temp. Reg. Sec. 1.6011-4T(b)(2)) ♦ Each of the other five categories of reportable transactions is defined at length in the Regulations. ♦ Exceptions: A transaction will not be considered a reportable transaction, or will be excluded from any individual category of reportable transaction ..., if the Commissioner makes a determination, by published guidance, individual ruling under paragraph (f) of this Section, or otherwise, that the transaction is not subject to the reporting requirements of the Section.
Form & Content of Disclosure Statement ***6011-4T(c)***	♦ There are 6 elements to be included in the disclosure statement for each reportable transaction. ♦ See detail of 6 required elements below. ♦ Disclosure statement ... "shall be presented in a format (preferably no longer than one page) similar to that shown in the Example" ... or "on such form as may be prescribed for use under this Section." ♦ See Example included in Regulations reproduced below. ♦ IRS has not released an official Form for reporting transactions subject to this Regulation.	
Definitions ***6011-4T(c)***		♦ Provides specialized definitions (with examples) for the following terms: (1) *Taxpayer ...* (2) *Corporation ...* (3) *Indirect Participation ...* (4) *Substantially Similar ...* "The term *substantially similar* includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Receipt of an opinion regarding the tax consequences of the transaction is not relevant .... ***Further, the term 'substantially similar' must be broadly construed in favor of disclosure.***"
Time of Providing Disclosure ***6011-4T(d)***	♦ ***For each taxable year.*** The disclosure statement for a reportable transaction must be attached to the taxpayer's Federal income tax return ***for each taxable year*** for which the taxpayer's Federal income tax liability is affected by the taxpayer's participation in the transaction. *(Continued)*	

Temp. Reg. Sec. 6011-4T	***REQUIREMENTS FOR INCLUDING STATEMENTS IN INCOME TAX RETURNS DISCLOSING PARTICIPATION IN CERTAIN TRANSACTIONS***	
Time of Providing Disclosure *6011-4T(d)* (Continued)	♦ ***Partnership and/or S Corporations.*** In the case of a taxpayer that is a partnership or S corporation, the disclosure statement for a listed transaction must be attached to the taxpayer's Federal income tax return for each taxable year ending with or within the taxable year of ***any*** partner or shareholder whose income tax liability is affected or is reasonably expected to be affected by the partnership's or the S corporation's participation in the transaction. ♦ ***Additional filing requirements.*** In addition, at the same time that any disclosure statement is first attached to the taxpayer's Federal income tax return, the taxpayer must file a copy of that disclosure statement with the Office of Tax Shelter Analysis (OTSA) Internal Revenue Service LM:PFTG:OTSA Large & Mid-Size Business Division 1111 Constitution Avenue Washington, D.C. 20224 ♦ Regardless of whether the taxpayer plans to disclose the transaction under other published guidance, the taxpayer must also disclose the transaction in the time and manner provided for under the provisions of this Section. ♦ ***Subsequent events.*** If a transaction becomes a reportable transaction (e.g., the transaction subsequently becomes one identified in published guidance as a listed transaction described in (b)(2) of this Section, or there is a change in facts affecting the expected Federal income tax effect of the transaction) on or after the date that taxpayer has filed the return for the first taxable year ..., the disclosure statement must be filed as an attachment to the taxpayer's Federal income tax return, ***next filed after the date the transaction becomes a reportable transaction*** (whether or not the transaction affects the taxpayer's or any partner's or shareholder's Federal income tax liability for that year). ♦ If a disclosure statement is required as an attachment to a Federal income tax return that is filed after June 14, 2002, but on or before 180 days after June 14, 2002, the taxpayer must either attach the disclosure statement to the return, or file the disclosure statement as an amendment to the return no later than 180 days after June 14, 2002.	
Form & Content of Disclosure Statement *6011-4T(d)*		♦ Form 8886 to be used to report transactions under this Regulation ♦ The IRS will release Form 8886, *Reportable Transaction Disclosure Statement* (or a successor form for use by taxpayers). ♦ The form must be completed in accordance with the instructions and attached to the appropriate tax return. ♦ An address is provided to which a copy of the disclosure statement should be sent.
Time of Providing Disclosure *6011-4T(e)*		♦ Substantially the same wording as that prescribed for pre-2003 transactions in Reg. Sec. described above.

Temp. Reg. Sec. 6011-4T	***REQUIREMENTS FOR INCLUDING STATEMENTS IN INCOME TAX RETURNS DISCLOSING PARTICIPATION IN CERTAIN TRANSACTIONS***	
Retention of Documents *6011-4T(e)*	♦ The taxpayer must retain a copy of all documents and other records related to a transaction subject to disclosure that are material to an understanding of the facts of the transaction, the expected tax treatment of the transaction, or the taxpayer's decision to participate in the transaction. ♦ Such documents must be retained until the expiration of the statute of limitations applicable to the ***first*** taxable year for which disclosure of the transaction was made in accordance with the requirements of this Section. ♦ Such documents generally include, but are not limited to the following: • Written analyses used in decision-making related to the transaction. • Correspondence and agreements between the taxpayer and any promoter, advisor, lender or other party to the reportable transaction that relate to the transaction. • Documents discussing, referring to or demonstrating the tax benefits arising from the reportable transaction, and • Documents, if any, referring to the business purposes for the reportable transaction.	
Treatment of Affiliated Groups *6011-4T(f)*	♦ An affiliated group of corporations that joins in the filing of a tax return under Section 1501 shall be considered a single taxpayer for purposes of this Section.	
Rulings & Protective Disclosures *6011-4T(f)*		♦ ***Requests for Ruling...*** (1) If a taxpayer is uncertain whether a transaction must be disclosed, the taxpayer may submit a request to the IRS for a ruling as to whether the transaction is subject to the disclosure requirements of this Section. Various other conditions and restrictions apply. ♦ ***Protective Disclosures...*** (1) If a taxpayer is uncertain whether a transaction must be disclosed under this Section, the taxpayer may disclose the transaction in accordance with the requirements of this Section and indicate on the disclosure statement that the taxpayer is uncertain as to whether the transaction is required to be disclosed under this Section and that the disclosure statement is being filed on a protective basis.
Retention of Documents *6011-4T(g)*		♦ Substantially the same as text in corresponding Regulation for pre-2003 transactions. However, • Documents must be retained until the expiration of the statute of limitations applicable to the ***final*** taxable year for which disclosure of the transaction is made. Note: in previous Regulation, reference was to the ***first*** taxable year, rather than to the final taxable year. • The Regulation specifically includes "marketing materials related to the transaction," in addition to all the other documents to be retained.
Effective Dates *6011-4T(g)...Old Regs* *6011-4T(h)...New Regs*	♦ ***WARNING ...*** the effective date rules are unbelievably complex. You must read these provisions for yourself. ♦ Generally, despite numerous interim cut-off date references in this Section, it appears that the IRS intends that these disclosure rules are to be applied to all transactions entered into before January 1, 2003.	♦ ...-4T(h) applies to Federal income tax returns filed after Feb. 28, 2000. ♦ However, paragraphs (a) through (g) of this Section apply to transactions entered into on or after January 1, 2003. ♦ The rules that apply with respect to transactions entered into on or before Dec. 31, 2002 are contained in ... -4T(g) old Regs in left-hand column.
Citation	♦ Temp. Regs as last amended June 14, 2002 by T.D. 9000	♦ Temp. Regs as last amended October 17, 2002 by T.D. 9017

DISCLOSURE STATEMENT FOR REPORTABLE TRANSACTIONS FOR TRANSACTIONS ENTERED INTO ON OR BEFORE DECEMBER 31, 2002

FORM & CONTENT OF STATEMENT
SIX ELEMENTS REQUIRED*

1. ***Identification of Transaction.*** The name, if any, by which the transaction is known or commonly referred to by the taxpayer. If no name exists, provide a short-hand designation of this transaction ...

2. ***Registration Information.*** A statement indicating whether, to the best knowledge of the taxpayer, the transaction has been registered as a tax shelter under Section 6111.

   If the transaction has been registered under Section 6111, indicate whether Form 8271 *Investor Reporting of a Tax Shelter Registration Number*, has been filed with the taxpayer's return and provide the registration number, if any, that has been assigned to the tax shelter.

3. A brief description of the ***principal elements*** of the transaction that give rise to the expected tax benefits, including the manner of the taxpayer's direct or indirect participation in the transaction.

4. A brief description of the expected ***tax benefits*** of the transaction (e.g., loss deductions, interest deductions, rental deductions, foreign tax credits, etc.)

5. An ***identification of each taxable year (including prior taxable years)*** for which the transaction is expected to have the effect of reducing the Federal income tax liability of the taxpayer, or any partner or shareholder of the taxpayer, and an ***estimate of the amount*** by which the transaction is expected to reduce the Federal income tax liability of the taxpayer or of any partner or shareholder of the taxpayer, for each such taxable year.

6. ***Promoter Identification.*** The names and addresses of any parties who promoted, solicited or recommended the taxpayer's participation in the transaction and who had a financial interest, including the receipt of fees, in the taxpayer's decision to participate.

*Source: Temp. Reg. Sec. 1.6011-4T(c)(1)(i) to (vi)

EXAMPLE OF FORM OF STATEMENT
TEMP. REG. SEC. 6011-4T(c)(2)

Corp. Name ______________________ EI # ____________

Address ____

DISCLOSURE STATEMENT FOR REPORTABLE TRANSACTION

1. ***Identification of Transaction:*** LILO-Country W
2. ***Registration Status Under Section 6111:*** Not registered
3. ***Description of Transaction:*** We leased a building from a municipality in W. We made an advance payment of rent of $89 million. The lease term is 34 years. The foreign municipality subleased the asset back from us for a term of 20 years. The foreign municipality has the option, at the end of the sublease term, to buy out our interest for $50 million. Our advance lease payment has been financed with a bank loan of $60 million. The foreign municipality placed $75 million of the advance rental payment in special accounts to satisfy the sublease and buyout obligations.
4. ***Principal Tax Benefits:*** Deductions for rental and interest payments in excess of income from leaseback rental payments.
5. ***Estimates of Expected Reduction of Federal Income and Tax Liability for Affected Taxable Years:***
   - Years 1999-2002 ... $5 million per year,
   - Years 2003-2013 ... $4 million per year, and
   - Years 2014-2017 ... $3 million per year
6. ***Promoters:*** Financial Institution Y

   (Address) ____________________

   (Telephone Number) ______________

   Professional Service Firm Z

   (Address) ____________________

   (Telephone Number) ______________

XX	TAX RETURN INSTRUCTIONS FOR TAX SHELTER DISCLOSURE STATEMENTS

According to the Regulations, the IRS is supposed to issue Form 8886 which is to be used for disclosing post-2002 reportable transactions.

Form 8886 is not yet available. However, in searching the *Forms* section of the IRS website, using the keywords "tax shelter disclosure statement" and "8886" resulted in hits on the instruction portions for various tax returns ... Forms 1120, 1120-S, 1065, etc.

The information is the same in the instructions, subject to minor wording changes. Below is the information from the instructions for Form 1120.

Reportable Transactions Entered Into Prior To January 1, 2003 (Pre-2003)

Tax shelter disclosure statement. For each reportable tax shelter transaction entered into **prior to January 1, 2003,** in which the corporation participated, directly or indirectly, the corporation must attach a disclosure statement to its return for each tax year that its Federal income tax liability is affected by its participation in the transaction. In addition, for the first tax year a disclosure statement is attached to its return, the corporation must send a copy of the disclosure statement to the Internal Revenue Service, LM:PFTG:OTSA, Large & Mid-Size Business Division, 1111 Constitution Ave., NW, Washington, DC 20224. If a transaction becomes a reportable transaction after the corporation files its return, it must attach a statement to the following year's return (whether or not its tax liability is affected for that year). The corporation is considered to have indirectly participated if it participated as a partner in a partnership or if it knows or has reason to know that the tax benefits claimed were derived from a reportable transaction.

Disclosure is required for a reportable transaction that is a listed transaction. A transaction is a listed transaction if it is the same as or substantially similar to a transaction that the IRS has determined to be a tax avoidance transaction and has identified as a listed transaction by notice, regulation, or other published guidance. See Notice 2001-51, 2001-34 I.R.B. 190, for transactions identified by the IRS as listed transactions. The listed transactions identified in this notice will be updated in future published guidance.

See Temporary Regulations section 1.6011-4T for details, including:

1. Definitions of reportable transaction, listed transaction, and substantially similar.
2. Form and content of the disclosure statement.
3. Filing requirements for the disclosure statement.

Reportable Transactions Entered Into After December 31, 2002 (Post-2002)

For reportable transactions entered into **after December 31, 2002,** use **Form 8886,** Reportable Transaction Disclosure Statement, to disclose information for each reportable transaction in which the corporation participated, directly or indirectly. Form 8886 must be filed for each tax year that the Federal income tax liability of the corporation is affected by its participation in the transaction. The following are reportable transactions.

- Any transaction that is the same as or substantially similar to tax avoidance transactions identified by the IRS.
- Any transaction offered under conditions of confidentiality.
- Any transaction for which the corporation has contractual protection against disallowance of the tax benefits.
- Any transaction resulting in a loss of at least $10 million in any single year or $20 million in any combination of years.
- Any transaction resulting in a book-tax difference of more than $10 million on a gross basis.
- Any transaction resulting in a tax credit of more than $250,000, if the corporation held the asset generating the credit for less than 45 days.

See the Instructions for Form 8886 for more details.

DISCLOSURE STATEMENT

FOR REPORTABLE TRANSACTIONS

As Required By Temp. Reg. Sec. 6011-4T and/or In Lieu Of Form 8886

Corp. Name ______________________________ EI # ______________

Address ______________________________

☐ Reportable Transactions Entered Into Prior to January 1, 2003 (Pre-2003)

☐ Reportable Transactions Entered Into after December 31, 2002 (Post-2002)

In Notice 2002-70, the IRS indicated that it has become aware of certain types of transactions that are being used by taxpayers to shift income from taxpayers to related companies purported to be insurance companies that are subject to little or no U.S. Federal income tax.

Notice 2002-70 indicated that these transactions generally involve a "taxpayer ... typically a(n) automobile dealer ... that offers its customers the opportunity to purchase an insurance contract through the taxpayer in connection with the products or services being sold. The insurance provides coverage for repair or replacement costs if the product breaks down or is lost, stolen, or damaged, or coverage for the customer's payment obligations in case the customer dies, or becomes disabled or unemployed.

"Taxpayer offers the insurance to its customers by acting as an insurance agent for an unrelated insurance company (Company X). Taxpayer receives a sales commission from Company X equal to a percentage of the premiums paid by Taxpayer's customers. Taxpayer forms a wholly-owned corporation (Company Y), typically in a foreign country, to reinsure the policies sold by Taxpayer. Promoters sometimes refer to these companies as producer owned reinsurance companies or 'PORCs.'"

Other arrangement specifics are discussed in Notice 2002-70, which states that ... "Many of the transactions described in this Notice have been designed to use a reinsurance arrangement to divert income properly attributable to Taxpayer to Company Y, Taxpayer's wholly-owned reinsurance company that is subject to little or no federal income tax. The Service intends to challenge the purported tax benefits from these transactions on a number of grounds."

Finally, Notice 2002-70 states that ... "Transactions ***that are the same as, or substantially similar to***, the transaction described in this Notice that involve taxpayers claiming entitlement to the benefits of Sections 501(c)(15), 806, or 831(b) are identified as 'listed transactions' for purposes of Reg. Sec. 1.6011-4T(b)(2) and Reg. Sec. 301.6111-2T(b)(2). ... Independent of their classification as 'listed transactions,' ... transactions that are the same as, or substantially similar to, the transaction described in this notice ***may already be subject to the disclosure requirements*** of Section 6011, the tax shelter registration requirements of Section 6111, or the list maintenance requirements of Section 6112 ... ."

The Service has provided no further clarification as to what is meant by its reference in Notice 2002-70 to "Transactions that are the same as, or substantially similar to, the transaction described in this Notice." Neither has the IRS clarified whether or not its concern is with ***only*** taxpayer arrangements involving either (1) parent-subsidiary or wholly-owned corporate subsidiary arrangements or (2) arrangements in which the taxpayers are claiming entitlement to the benefits of Sections 501(c)(15), 806 or 831(b).

Because of (1) this lack of clarification by the Internal Revenue Service and (2) the all-inclusive language in Temp. Regs. Section 1.6011-4T as applied to transactions entered into before or after January 1, 2003, the taxpayer is not certain whether or not its activities as they relate to its producer owned reinsurance corporation are subject to the disclosure statement reporting requirements.

This statement is included on a protective basis in the event such reporting is deemed to be required.

(Continued)

DISCLOSURE STATEMENT

FOR REPORTABLE TRANSACTIONS

As Required By Temp. Reg. Sec. 6011-4T and/or In Lieu Of Form 8886

1. *Identification of Transaction:*
   - PORC (Producer Owned Reinsurance Company). Country of incorporation ______________
   - This PORC is not a wholly-owned subsidiary.
   - This PORC is a member of a brother-sister controlled group of corporations.
   - This PORC is ***not*** claiming any tax benefits provided by Sections 501(c)(15), 806 or 831(b).
   - Identification of other members of the brother-sister controlled group of corporations.
   - ____
2. *Registration Status Under Section 6111:* Not registered
3. *Description of Transaction:*
   - For valid business reasons, the brother-sister corporate structure arrangement has been set up.
   - The PORC receives income in the form of reinsurance premiums ______________________

     ____
   - (If Applicable) The PORC also receives other insurance premiums in connection with accident and credit life insurance policies. ______________________________

     ____
4. *Principal Tax Benefits:*
   - None, since all income is being reported by the appropriate recipient entities. ______________
   - ____
   - ____
5. *Estimates of Expected Reduction of Federal Income and Tax Liability for Affected Taxable Years:*
   - PORC entity was incorporated: ______________________________ (Date entity created)
   - List all years from date of incorporation through date of tax return here ______________
   - No estimated expected reduction of tax liabilities, since all income is being reported by the appropriate recipient entities.
   - ____
6. *Promoters:*

Financial Institution Y	Professional Service Firm Z
(Address) ______________	(Address) ______________
(Telephone Number) ______________	(Telephone Number) ______________

WARNING: ***The responses above are suggested generalizations. They may or may not be appropriate to summarizing the PORC reinsurance arrangement. Since these arrangements vary significantly in practice, careful consideration should be given to the specific disclosures provided.***

To assure accuracy and agreement on the form and extent of these disclosures, the review and approval checklist below may be useful. This information could be retained on a "working" internal copy of the statement, but deleted from the statement included in the tax return filed with the Internal Revenue Service.

The disclosures above have been carefully prepared and reviewed and approved by the following:

- ☐ ______________ ***(CPA Firm Partner)*** ______________ ***(Date)***
- ☐ ______________ ***(PORC Promoter)*** ______________ ***(Date)***
- ☐ ______________ ***(Dealer/Principal)*** ______________ ***(Date)***
- ☐ ______________ ***(Attorney, if appropriate)*** ______________ ***(Date)***

SIMPLIFIED, ONE-SIZE-FITS-ALL (?) DISCLOSURE STATEMENT

PRACTICE GUIDE

CHECKLIST FOR EVALUATING EXPOSURE TO IRS ATTACK ON PORCs

Participant(s)	___Dealer ___Spouse ___Child or Children ___Others ______________
Entity / Entities Involved	Corporation: ___C Corp. ___S Corp. ___Holding Company ___Other __________ Other: ___LLC ___Partnership ___LLP ___Other __________ Year of Formation: ______________ Shareholders: ______________ Officers: ______________
Capitalization & Funding	Is the PORC entity adequately funded? ______________ If this activity has been operating at a loss, how have the funds to cover its costs & expenses been provided? ______________
Documentation	Is there adequate documentation in the Minutes? ___Yes ___No Are the books & records adequate? ___Yes ___No. Is there a business plan? ___Yes ___No

OPERATING RESULTS

	Total Receipts	*Total Expenses*	*Net Income (Loss)*
Fifth prior year			
Fourth prior year			
Third prior year			
Second prior year			
First prior year			
Current year (projected)			
Next year - projected			
Next two years - projected			
Average for three prior years			
Average for five prior years			

SHAREHOLDER LOAN ISSUES*

1. Do loan documents exist? ___Yes ___No.
2. Does the loan documentation appear to be adequate? ___Yes ___No.
3. Is the receivable balance collateralized or otherwise secured? ___Yes ___No.
4. Does the security or collateral appear to be adequate? ___Yes ___No.
5. Has interest been regularly charged and paid? ___Yes ___No. If not, why not? ______________
6. Is there a fixed repayment schedule? ___Yes ___No. If not, why not? ______________
7. Realistically, what limits exist in connection with what goes in and out of this account? ______________
8. Has the total loan balance each year, net of repayments, been steadily increasing? ___Yes ___No.
9. What is the average loan balance amount for the

	Mid-year	Year-End
• Past 3 years	$ ________	$ ________
• Past 5 years	$ ________	$ ________
• Past 10 years	$ ________	$ ________

10. Are loan repayments made substantially through bookkeeping entries and salary adjustments? ___Yes ___No.

* For other issues, see *Dealer Tax Watch*, June 2001, *Checklist For Identifying Possible Loan-Constructive Dividend Problem Areas.*

PRACTICE GUIDE

CHECKLIST FOR EVALUATING EXPOSURE TO IRS ATTACK ON PORCs

Factors to Consider	*Yes*	*No*	*Comments*
1. Is the PORC a member of a brother-sister group of controlled corporations?			
2. Is the PORC a wholly-owned subsidiary of a parent corporation?			
3. Has the reinsurance company made an election under Section 953(d) to be taxed as a U.S. corporation for Federal income tax purposes? • If yes, has IRS acknowledged acceptance of the election? • What country is the domicile of the reinsurance company? ______________?			
4. Does the arrangement involve a foreign corporation?			
5. Is the PORC claiming the benefit of Sec. 501(c)(15) ... non-life insurance companies are tax exempt if premiums written for the year do not exceed $350,000? • If yes, has tax exemption been confirmed by the IRS?			
6. Is the PORC claiming the benefit of Section 806 ... phased-out deduction for certain life insurance company taxable income not in excess of $15 million?			
7. Is the PORC claiming the benefit of Section 831(b) ... qualifying non-life insurance companies whose net written premiums are between $350,000 and $1,200,000 can elect to be taxed solely on their investment income?			
8. Does the PORC receive income (in addition to extended service contract) from assuming other third-party unrelated risks, such as from credit, life, accident & health, GAP insurance, insured finance reserve and/or after-market product car protection (i.e., paint protection, fabric protection etch/theft protection coverage)? • If yes, which additional products are involved? ______________________ • Provide relative percentages of income from each? __________________%			
9. *"Exotic" Arrangements.* As an alternative to an individually-owned PORC, does the reinsurance arrangement involve the dealer as a non-controlling (less than 10%) shareholder in a controlled foreign corporation (CFC)? • Are there multiple classes of stock outstanding? Describe _______________ • If yes, is the dealer protected (or insulated) from being adversely affected by losses experienced by other dealers participating in the same entity? • Are you familiar with the provisions of Section 954?			
10. *Listed Transaction Status.* Has the reinsurance arrangement been reported to the IRS as a listed transaction? • If yes, which years returns have included disclosure statements?			
11. *Shareholder Loans.* Has the dealer borrowed money from the PORC in the past? • If yes, to what extent is there exposure to recharacterization of the loans as constructive dividends by the IRS? See *Shareholder Loan Issues* (facing page). • Have you reviewed the *William L. McCurley* (T.C. Memo 1997-371) case to see if there is similar exposure to attack by the IRS?			
12. *Capitalization.* Is the PORC adequately capitalized?			
13. *Questionable Investments.* Does the balance sheet reflect investments in personal use assets such as condominiums, boats, etc.? Describe ___________________			
14. *Commissions.* Were insurance commissions reduced ***after the formation*** of the PORC? If so, what were the business reasons for that change? Describe _______ • Has the dealer directed that premiums be paid to other entities or elsewhere?			
15. Is there anything unusual about the reinsurance arrangement?			
16. *Oversubmits & Other Issues.* Have you reviewed the *William Wright* (T.C.M. 1993-328) case? Does similar exposure exists to "sham transaction" arguments?			

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