Notice 2003-34

I. PURPOSE

Treasury and the Internal Revenue Service have become aware of arrangements, described below, that are being used by taxpayers to defer recognition of ordinary income or to characterize ordinary income as a capital gain. The arrangements involve an investment in a purported insurance company that is organized offshore which invests in hedge funds or investments in which hedge funds typically invest. This notice alerts taxpayers and their representatives that these arrangements often do not generate the claimed Federal tax benefits.

II. BACKGROUND

The typical arrangement involves a Stakeholder, subject to U.S. income taxation, investing (directly or indirectly) in the equity of an enterprise ("FC"), usually a corporation organized outside the United States. FC is organized as an insurance company and complies with the applicable local laws regulating insurance companies.

FC issues "insurance or annuity contracts" or contracts to "reinsure" risks underwritten by insurance companies. Some of the contracts do not cover insurance risks. Other contracts significantly limit the risks assumed by FC through the use of retrospective rating arrangements, unrealistically low policy limits, finite risk transactions, or other similar devices.

FC's actual insurance activities, if any, are relatively small compared to its investment activities. FC invests its capital and the amounts it receives as consideration for its "insurance" contracts in, among other things, hedge funds or investments in which hedge funds typically invest. As a result, FC's portfolio generates investment returns that substantially exceed the needs of FC's "insurance" business. FC generally does not currently distribute these earnings to Stakeholder.

Stakeholder takes the position that FC is an insurance company engaged in the active conduct of an insurance business and is not a passive foreign investment company. Therefore, when Stakeholder disposes of its interest in FC, it will recognize gain as a capital gain, rather than as ordinary income.

III. DISCUSSION

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

Treasury and the Internal Revenue Service are concerned that in some cases FC and its Stakeholders are inappropriately claiming that FC is an insurance company for Federal income tax purposes to avoid tax that otherwise would be due. The Service will challenge the claimed tax treatment in appropriate cases, as outlined below.

A. Definition of Insurance

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

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

Treasury and the Service are concerned that any risks assumed under the contracts issued by FC may not be insurance risks. Treasury and the Service are also concerned that the terms of the contracts may significantly limit the risks assumed by FC.

B. Status as an Insurance Company

A corporation that is an insurance company for Federal income tax purposes is subject to tax under subchapter L of the Internal Revenue Code. For this purpose, 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. 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. § 1.801-3(a) of the Income Tax Regulations; § 816(a) (which provides that a company will be treated as an insurance company only if "more than half of the business" of that company is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies).

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), cert. denied, 414 U.S. 1143 (1974). To determine whether FC qualifies as an insurance company, all of the relevant facts will be considered, including but not limited to, the size and activities of its staff, whether it engages in other trades or businesses, and its sources of income. See generally Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932); 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. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1971); Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933).

In Inter-Am. Life Ins. Co., 56 T.C. at 506-08, the Tax Court applied the standard of § 1.801-3(a), and held that the taxpayer was not an insurance company because it was not using its capital and efforts primarily in earning income from the issuance of insurance. The court in particular noted the disproportion between investment income and earned premiums. The court also noted the absence of an active sales staff soliciting or selling insurance policies.

Even if the contracts qualify as insurance contracts as explained above, the character of all of the business actually done by FC may indicate that FC uses its capital and efforts primarily in investing rather than primarily in the insurance business.

C. Possible Tax Treatment of Stakeholder's Interest in FC

Sections 1291-1298 provide special rules for taxing an investment in a foreign corporation that is a passive foreign investment company (as defined in § 1297). These rules impose current U.S. taxation (or similar treatment) on U.S. persons that earn passive income through a foreign corporation. A foreign corporation is a passive foreign investment company if (1) 75 percent or more of the gross income of such corporation for the taxable year is passive income, or (2) the average percentage of assets (as determined in accordance with § 1297(e)) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent. Section 1297(a). For these purposes, passive income generally means any income which is of a kind which would be foreign personal holding company income as defined in § 954(c). Foreign personal holding company income includes dividends, interest, royalties, rents, annuities, and gains from the sale or exchange of property giving rise to such types of income. Section 954(c)(1).

Section 1297(b)(2)(B) provides an exception to passive income for any income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation (the insurance income exception). If FC would not be subject to tax under subchapter L if it were a domestic corporation (for the reasons discussed above), then the insurance income exception to passive income will not apply, and FC will be subject to the general income and assets tests described above. Additionally, even if FC would be subject to tax under subchapter L if it were a domestic corporation, the insurance income exception may not apply to FC because this exception is applicable only to income derived in the active conduct of an insurance business.

The Service will scrutinize these arrangements and will apply the PFIC rules where it determines that FC is not an insurance company for federal tax purposes.

III. DRAFTING INFORMATION

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