

SCRIBNER, HALL & THOMPSON, LLP

SUITE 1050

1875 EYE STREET, N. W.

WASHINGTON, D. C. 20006-5409

(202) 331-8585

FAX (202) 331-2032

THOMAS C. THOMPSON, JR.
MARK H. KOVEY
STEPHEN P. DICKE
PETER H. WINSLOW
SUSAN J. HOTINE
BIRUTA P. KELLY
GREGORY K. OYLER
LORI J. BROWN
SAMUEL A. MITCHELL
JOSEPH A. SERGI

FRED C. SCRIBNER, JR. (1908-1994)
LEONARD W. HALL (1900-1979)

MEMORANDUM

Re: IRS Removes PORCs from Tax Shelter Listing

From: Mark H. Kovey

Date: September 27, 2004

The IRS eliminated transactions involving producer-owned reinsurance companies (“PORCs”) as “listed transactions” for purposes of the requirements to report a tax shelter on tax returns, to maintain a tax shelter list of participants for provision to the IRS and to register a tax shelter with the IRS. As designated by the IRS in Notice 2002-70 for inclusion in tax shelter “listed transactions,” the PORC typically claimed tax benefits by using (a) the tax exemption for small nonlife insurance companies in I.R.C. § 501(c)(15); (b) the deduction under I.R.C. § 806 for certain small life insurance companies with life insurance company taxable income not in excess of \$15,000,000; or (c) the election under I.R.C. § 831(b), which allows nonlife insurance companies with net written premiums of \$1,200,000 or less to be taxed solely on investment income.

In Notice 2004-65, issued on September 24th, the IRS removed PORCs from the listed transactions characterization because, from various examinations, there were fewer abusive transactions than anticipated, and because the 2004 amendments to I.R.C. § 501(c)(15) are expected to prevent the I.R.C. § 501(c)(15) exemption from being used in the future by PORC-type arrangements. The elimination of the listed transactions burden for PORCs and substantially similar transactions described in Notice 2002-70 is effective for taxable years for which the due date of the return (measured with available extensions) is after September 24, 2004. However, Notice 2004-65 also warned that the removal of PORCs from the category of listed transactions does not free the PORC from possible scrutiny, if it is being used to shift income from taxpayers to the PORC as described in Notice 2000-

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70, nor eliminate the possibility that a PORC transaction may still be subject to disclosure, registration and list maintenance requirements for some reason other than being a listed transaction.

In a companion notice issued on the same day, Notice 2004-64, the IRS reminded taxpayers that I.R.C. § 501(c)(15) tax exemption for small nonlife insurance companies is much harder to satisfy since the amendments enacted in April in the Pension Funding Equity Act of 2004. The new amendments apply for taxable years beginning after December 31, 2003 (with a limited transition rule for insurance companies subject to state court-supervised rehabilitation or liquidation proceedings). As amended, I.R.C. § 501(c)(15) requires a nonlife insurance company to meet a higher income threshold based on gross receipts, as well as a more-than-50-percent test for its premiums-to-gross-receipts ratio and for its insurance-vs.-noninsurance-business ratio for qualification as an insurance company.¹ Notice 2004-64 warned that the IRS will continue to scrutinize the eligibility of entities claiming to be tax-exempt under the former or amended I.R.C. § 501(c)(15), regardless of whether the exemption is claimed pursuant to an existing determination letter issued by the IRS or on a filed tax return.

Please call or e-mail me with any questions.

¹ Under prior law, an insurance company could qualify for tax-exemption if its primary and predominant business was reinsuring risks and if its net written premiums did not exceed \$350,000 for the year. Now, the tax-exemption will apply only if more than half the business of the company during the year is issuing insurance and annuity contracts, or reinsuring risks, and if gross receipts of the company (and affiliated companies) do not exceed \$600,000, and more than half of the gross receipts consist of premiums. These changes are likely to eliminate the tax-exemption for most PORCs based on the affiliation rule for determining the amount gross receipts. To test whether the \$600,000 gross receipts limit is violated, the rules require aggregation of gross receipts of companies that are more than 50-percent owned by the same persons, and by related companies and family members.