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Substance Over Form Revisited – The UPS Case And Captive Insurers

PHILLIP C. ENGLAND[1]

In the summer of 1999, the Tax Court (78 TCM (CCH) 262) ruled on a matter involving United Parcel Service and their restructuring of certain customer related insurance coverage transactions arising from the shipment of packages. UPS charged each customer an "excess value charge" or "EVC" on packages with a certain value and UPS was allowed by its tariff to remit the EVC's to an insurance company as a premium for excess valuation cargo insurance on behalf of the customer.

After looking at various ways to deal with the EVC activity, which created a substantial flow of revenue, UPS decided to enter into an agreement with an unrelated insurer whereby UPS remitted EVC's as insurance premiums to such insurer ("NUF", a subsidiary of AIG, was selected) on a monthly basis net of certain claims paid. Also as part of the arrangement, NUF would use a UPS owned Bermuda captive insurance company ("OPL" formed in 1983 by UPS) as a reinsurer and remit to OPL 100% of the amounts remitted to NUF from UPS less a small commission and certain costs. Immediately before the UPS-NUF-OPL arrangement was to become effective (1/1/84), UPS spun off OPL to UPS' shareholders as a taxable dividend of one share of OPL stock for each UPS share. Thus, as of 12/31/83 (the date of the spin off) the shareholders of UPS were essentially the same as the shareholders of OPL.

The IRS attacked the foregoing on several grounds but basically argued that the arrangement was essentially a "sham" with no economic substance and no business purpose other than tax savings and simply a diversion (i.e. assignment) of income in fact earned by UPS to another commonly controlled offshore entity.

The Tax Court essentially agreed with the IRS and treated the whole arrangement as a sham, largely based on their perception that UPS continued to do most of the same business functions surrounding the EVC activity after the restructuring that it had done prior to the restructuring.

This case was not focused on the legitimacy of OPL as a reinsurer or on captives specifically; however, the fact that a captive was at the heart of the matter made this an important, and somewhat unsettling decision, for companies that utilize captive insurers or reinsurers.

In the summer of '01 (June 20th), the 11th Circuit Court of Appeals reversed and remanded the Tax Court's decision (see UPS of Am. Inc. v. C.I.R., (WL 690415) (11th Cir. 2001)).

In reversing the Tax Court, the 11th Circuit found that there was

some economic substance to the restructuring since there were genuine obligations enforceable by unrelated parties. For example, the 11th Circuit found that there existed "a real insurance policy between UPS and NUF." Furthermore, the 11th Circuit found that even if there were a conduit flavor to the stream of money through NUF, "OPL is an independent taxable entity that is not under UPS' control," (remember the spin off?), thus, no sham for assignment of income purposes.

As for business purpose, the 11th Circuit, unlike the Tax Court, found UPS' transaction to have an "adequate" business purpose and took a rather broad view by stating that a transaction has a business purpose "when we are talking about a going concern like UPS, as long as it figures in a bona fide profit-seeking business."

The case was remanded back to the Tax Court to consider the IRS' argument that even with a good business purpose it has the authority under Sections 482 and 845 of the Code to reallocate income between UPS and OPL (commonly controlled entities).

In analyzing this case, in the first instance, it is probably a pretty good win for the taxpayer. The IRS, however, under Section 482 of the Code (and Section 845 where a reinsurance agreement exists), can always reallocate income among a commonly controlled group of corporations in order to accurately reflect the true and proper income of each member in the context of transactions among such group members, and it remains to be seen as to what UPS (as opposed to OPL) should "earn" and report as income from its activities involving EVC's.

Also, while the IRS lost its argument that this transaction should not be respected for tax purposes because it lacked economic substance (the sham transaction doctrine) or that it lacked any legitimate non-tax business purpose (the business purpose doctrine), these two doctrines are so ingrained in substantive tax law and so oriented towards the specific facts and circumstances surrounding a specific transaction that they will certainly be used by the IRS in the future.

While many advisors to companies with captives are claiming a clear win for captive insurance companies generally, the better view might be that the case is simply a "win" with regards to the use of a captive for a legitimate business purpose. In sum, the use of a captive should not create a "taint" if a taxpayer's transaction is real (i.e. has substance).

Finally, it would seem that a company with a captive or a company who wants a captive can, as a result of this case, have somewhat greater comfort that a properly formed and capitalized captive can, within case law guidelines, serve as an insurer or reinsurer and will be respected for tax purposes (and for purposes of premium deductions). Along with other developments in 2001 (notably Rev. Rul. 2001-31 by which the IRS abandoned its long held view that a captive can simply, in many cases, be collapsed into its parent and treated along with its parent as a single entity), it would seem that this case could cause the IRS to be more accommodating to the existence and operation of a captive insurance entity and adds a level of comfort to those companies who are looking to create a captive or expand the role of one that already exists within a corporate group.

Phillip C. England is a lawyer in the New York office of Anderson Kill & Olick, P.C. He is a member of the New York and New Jersey Bars. He has a J.D. from the University of North Carolina at Chapel Hill and an LLM (in taxation) from New York University. He wrote a previousarticle on the UPS case which appeared in Corporate Counsel (Oct. 2000).

ANDERSON KILL & OLICK, P.C.

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