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"Substance Over Form" - An Old Tax Concept Still Quite Alive - A Lesson In Insurance Planning

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In *ACM Partnership v. Commissioner*, (3rd Cir. 1998) the Third Circuit Court of Appeals served notice that the old and familiar rule of substance-over-form still has real vitality. In that case, the court determined that a structured transaction, which on its face satisfied all the statutory requirements for a capital loss deduction had insufficient economic substance to be respected for tax purposes. A recent case, *United Parcel Service v. Commissioner* (1999 U.S. Tax Court), carries this concept into the area of insurance captives.

United Parcel Service ("UPS") is the largest motor carrier in the United States and a provider of small package and parcel pickup and delivery services. The rates charged by UPS to its customers are governed by tariffs, which were submitted to both the Interstate Commerce Commission ("ICC") and the various states. In 1983, UPS amended its tariff with the ICC in order to allow a third-party insurance company to provide optional insurance coverage to UPS customers for packages which were worth more than $100 ("excess value charges," or "EVCs"). In 1984, the cost of this optional coverage was 25 cents per $100 of additional coverage over the first $100 of insurance coverage, which was provided for all packages as part of the basic UPS shipping charge. UPS arranged to have this insurance coverage provided by National Union Fire Insurance Co. of Pittsburgh, Pennsylvania ("NUF"), an unrelated third party, and a subsidiary of AIG. NUF reinsured 100% of the covered risk with a subsidiary spun-off from UPS, Overseas Partners Ltd. ("OPL").

For the taxable year ending December 31, 1984, UPS did not include the EVCs it collected in its taxable income despite the fact that it continued to carry on the same basic activities, with respect to the excess value amounts, that it had in prior years. During 1984, UPS continued to collect the EVCs and deposit the funds into its bank accounts. UPS also continued to process all claims for lost and damaged parcels. UPS paid customer claims by checks drawn from its own account. On a monthly basis, UPS remitted the net amounts of EVC's to NUF without reducing the amount transferred by any amount uncollected or any cost it incurred in the collection of delinquent EVCs. NUF would then subtract its expenses and remit the net amounts to OPL.

As a general matter, it is a basic tenet of our system of taxation that income must be taxed to the party that earns it. Under the theory of anticipatory assignment of income, taxation cannot be avoided simply by entering into a contractual arrangement to divert the income to another party prior to receipt. In the instant case, the tax court held that UPS should be taxed for the EVC income it received from its customers in 1984, under the theory that UPS's transfer of premiums to OPL was an anticipatory assignment of income. The court looked at the issue of whether UPS, rather than NUF and OPL, earned the EVCs, and determined that UPS's involvement with the EVCs was substantially the same both before and after January 1, 1984, when it had included the EVCs in its taxable in-

come. The Court ruled that the EVC's reprsented income actually earned by UPS.

In determining whether the insertion of NUF and OPL into the EVC transactions had any real substance, the court first addressed whether UPS had a business purpose, other than tax avoidance, for engaging in the transaction. Such an analysis requires the court to subjectively analyze the taxpayer's intent. The court stated that, "[w]hile a taxpayer may structure a transaction to minimize tax liability, that transaction must have economic substance if it is to be respected for tax purposes." The court then considered each of UPS's justifications for the structuring of the transaction, and concluded that none of them had any real business purpose or economic substance.

The first justification raised by UPS was its fear that their continued receipt of EVC income would violate various state insurance laws. In response, the court noted that such a fear would only constitute a legitimate business purpose if UPS had a good faith concern that its continued receipt of the excess value income was illegal. With the exception of one conversation between the head of UPS's insurance department and a Vice President of UPS's insurance broker, the court determined that UPS conducted no real inquiry into whether its continued receipt of the EVC income violated any state laws. In addition, the court noted that federal law appears to preempt state law with respect to the liabilities of interstate carriers such as UPS. Therefore, the court held this justification to be insufficient.

The second justification raised by UPS was its hope that the EVC business could leverage OPL into a new reinsurance company, which could ultimately become a full-line insurance company. In rejecting this purported justification, the court noted that "[we] have no doubt that transferring the profits from the EVC activity, tax free, could provide OPL with the capital to become a full-line insurer of other risks. But any investment of money into OPL could accomplish this purpose. The question is whether [UPS] earned, and must pay tax . . . The purpose for which the profits were ultimately used, does not answer the question before us."

The third justification raised by UPS was its belief that restructuring the EVC business would (i) permit UPS to raise its shipping rates, and/or (ii) increase protection for the assets of UPS's core transportation function from the risks associated with assuming liability arising from declared excess values. In rejecting such justification, the court noted that under the facts of the case it was unlikely that UPS shifted the income to OPL to justify raising its rates and with respect to core asset protection the court felt that UPS either had or could have sufficient general coverage to accomplish such goal with or without the EVC activity.

In conclusion, any structure which generates a substantial tax benefit must meet the substance-over-form test and business purpose test. These are old concepts in business law but still provide a formidable sword to the IRS in audit situations.

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