OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
November 5, 1998

CC:DOM:FS:FI&P

November 5, 1998

UILC: 162.04-02

Number: **199915004**
Release Date: 4/16/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Internal Revenue Service National Office Field Service Advice

This Field Service Advice responds to your memorandum dated
Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
A =
B =
C =
D =
E =
F =
G =
H =
I =

J	=
K	=
L	=
M	=
N	=
State I	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Date 5	=
a%	=
b%	=
c%	=
d%	=
e%	=

ISSUES:

1. Whether amounts paid or accrued to A, a captive insurance company, by "brother-sister" corporations are deductible insurance premiums under IRC section 162.

2. Whether the Service continues as a matter of law to defend the disallowance of deductions of "premiums" paid by brother sister corporations.

3. Whether the present case is distinguishable from Humana Inc. v. Commissioner, 881 F. 2d 247 (6th Cir. 1989) and Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42 (1997), two cases which allowed deductions for brother-sister premiums.

4. Whether the facts in the present case are adequately developed to support pursuing the brother-sister issue.

CONCLUSION:

1. In response to your second inquiry, the Service continues to defend its position reflected in Rev. Ruls. 77-316 and 88-72.

2. In response to your fourth inquiry, we conclude that further factual development is needed.

3. Once the additional information and documents are obtained, we may then be able to respond more fully to your first and third inquiries.

FACTS:

B purports to be a charitable organization existing for the purpose of operating and maintaining C in State I. B was granted tax exempt status under IRC § 501(c)(3). B, once supported primarily from the proceeds of the sale of real property willed to B, now carries on significant business operations and investment through numerous subsidiaries. B formed Taxpayer in Year 1 to take advantage of the provision of IRC § 512(b)(13) which enables an exempt organization under certain circumstances to avoid tax on unrelated business income by funneling it through a corporation controlled by the tax exempt organization. B owns a% of the stock of Taxpayer.

The examination team examining B and its for profit subsidiaries is preparing a RAR proposing adjustments to the consolidated return filed by the various subsidiaries and proposing revocation of the exempt status of B, or, in the alternative, the taxation of unrelated business income to B. The issue concerning the treatment of premiums paid to A is one of several issues with respect to which Counsel is seeking field service advice in this case.

The Service has determined that Taxpayer serves no valid business purpose. The Service anticipates asserting that Taxpayer should be disregarded as a separate entity.

A is the wholly owned subsidiary of Taxpayer. Taxpayer and its subsidiaries, including A, file a consolidated return. Taxpayer also wholly owns D, E, and F. A was formed on Date 5. Taxpayer acquired   shares of A's dollar par stock in exchange for a capital contribution of $.

A is a pure captive insurance company which State I defines in its statute as a company that insures the risks of only the parents and affiliated companies. A "parent" is defined by State I's statute as a corporation, partnership, or individual that directly or indirectly owns or controls or holds the power to vote more than 50% of the outstanding voting securities of a pure captive insurance company.

The trustees of B approved the formation of the captive insurance subsidiary as a viable financial vehicle for providing worker's compensation, general liability, property, and automobile insurance for B and its subsidiaries. After its formation, A issued four blanket insurance policies to B and its affiliated companies. B determined it was cost effective to have one policy covering all the entities. A issued the following policies: property deductible, worker's compensation, automobile liability and general liability. The "premiums" charged by A were based on a risk exposure analysis of each entity to which the policies would be allocated.

These “premiums” were billed to the separate entities and were paid by that company or its parent.

A agreed to pay the first $ of liability for each occurrence under the policy. The remaining liability was reinsured with G. The policy limits for employer liability, automobile liability, and general liability were either one or two million dollars. The worker’s compensation policy was within the statutory limits prescribed by State I. B also purchased excess liability and umbrella policies for occurrences in excess of the A policy limits.

A has no employees. A is managed by a three member board of directors comprised of H, a current B trustee; I, a former B trustee; and J, manager of B. B provided clerical assistance to A. Persons providing services to A were compensated directly by B.

K was the risk management broker for B. L, who had been the risk manager of B, became the president of A. K entered into an insurance management agreement with B in Year 2. A paid management fees in the amounts $ and $ in Year 3 and Year 4 respectively. Those amounts were deducted on the consolidated return.

The total premiums earned by A in Year 3 and Year 4 were $ and $, respectively. Of those amounts, b% and c% appear to be attributable to B’s or Taxpayer’s other taxable subsidiaries in Year 3 and Year 4, respectively. Premiums received from unrelated third parties (M and N) totaled d% and e% for Year 3 and Year 4, respectively.

The examining agent proposes to disallow deductions for premiums in the amount of $ in Year 3 and $ in Year 4. These are the premiums paid to A by the brother sister subsidiaries.

LAW AND ANALYSIS

Section 162(a) of the Internal Revenue Code allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...”. Generally, premiums paid for insurance are deductible under § 162(a), if directly connected with the taxpayer’s trade or business. Treas. Reg. § 1.162-1(a). However, amounts set aside as reserves for the payment of anticipated losses, as a form of self-insurance, are not deductible business expenses under that section. Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985). Although the Internal Revenue Code does not define the term “insurance”, insurance is not found where the insurance company in question has not assumed a substantial underwriting or economic risk. See, e.g., Allied

Fidelity Corp. v. Commissioner, 572 F. 2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978).

In Helvering v. LeGierse, 312 U.S. 531, 539 (1941), the United States Supreme Court, addressing the question of what constitutes "insurance" for federal income tax purposes, stated that there must be "risk shifting" (from the insured's perspective) and "risk distribution" (from the insurer's perspective). In LeGierse, because the insurance policy in question was found not to constitute insurance even though it was issued by a fully regulated commercial insurer, the Court indicated that the test is one of substance and not of form. In addition to the necessary elements of risk shifting and risk distribution, courts have held that a transaction, to be considered insurance, must involve an "insurance risk," and must be for "insurance in a commonly accepted sense." E.g., AMERCO, Inc. v. Commissioner, 96 T.C. 19, 38, aff'd. 979 F.2d 162 (9th Cir. 1992). The deductibility under I.R.C. section 162(a) of the amounts paid by Taxpayer to A will depend upon whether the policies are insurance transactions pursuant to the test articulated in LeGierse.

A. Service position.

In Rev. Rul. 77-316, 1977-2 C.B. 53, the Service addressed the deductibility of insurance premiums in brother-sister captive insurance company setting forth an "economic family" concept. The Service ruled that payments for "insurance" between related corporations did not constitute true insurance but rather are reserves set aside for "self-insurance". The result in such a situation is that the entity that incurs a loss also bears the economic burden of that loss. Accordingly, the Service opined that the corporations participating in a captive insurance arrangement, although separate in form, in reality are one economic family.

The Service, in Rev. Rul. 77-316, discussed three situations concerning a taxpayer's attempt to seek insurance through its wholly-owned subsidiary. Situation 1 involved a taxpayer and its subsidiaries who entered into a contract of fire and casualty insurance with taxpayer's wholly-owned "insurance" subsidiary. Situation 2 involved a taxpayer and its subsidiaries who entered into a contract of insurance with an unrelated insurer, but immediately transferred 95 percent of the policy risk to taxpayer's wholly-owned "insurance" subsidiary through a reinsurance transaction. Situation 3 involved a taxpayer and its subsidiaries who entered into an insurance agreement with taxpayer's wholly-owned "insurance" subsidiary, who then transferred 90 percent of the risks to an unrelated insurance company through a reinsurance transaction.

The Service concluded that there is no shifting of risk with respect to each transaction to the extent that the "insurance" subsidiary had retained risk associated with the policies. The Service reasoned that the taxpayer, its non-

insurance subsidiaries, and its insurance subsidiary represented one "economic family." Accordingly, those who bore the burden of loss are the same as those who incurred the loss. In situation 1, 100 percent of the premiums are not deductible; in situation 2, 95 percent of the premiums are not deductible, and in situation 3, 10 percent of the premiums are not deductible.

In Rev. Rul. 88-72, 1988-2 C.B. 31, the Service clarified its position set forth in Rev. Rul. 77-316. In that ruling, the taxpayer entered into an insurance agreement with its wholly-owned "insurance" subsidiary. The subsidiary, however, also insured risks from unrelated parties, and was regulated by the states where it did business. The Service concluded that the arrangement between the taxpayer and its subsidiary did not involve sufficient risk transfer to be characterized as insurance, despite the fact that the risks were distributed by the subsidiary's retention of unrelated risks. The Service explained that although the unrelated risks accepted by the subsidiary increased the likelihood that the subsidiary would remain solvent in the event of a loss, the acceptance of unrelated risks did not "reallocate" the risks accepted from the taxpayer. The Service emphasized that the taxpayer retained an economic stake in whether its own losses or its subsidiary's losses occur.

B. Court decisions.

No court has fully accepted the economic family theory articulated by the Service in Rev. Ruls. 77-316 and 88-72. Adhering to the principles set forth by the United States Supreme Court in Helvering v. LeGierse, supra, and Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), courts have generally applied a five-part analysis in determining whether or not insurance premiums paid in a situation involving a brother-sister captive insurance company are deductible under section 162(a).

1) Separate taxable entity or sham.

Courts' initial inquiry is whether the captive insurer is a separate taxable entity or is a sham. In Moline Properties, the Court stated the general rule that, absent an exception, e.g,. where the arrangement is a sham or a tax fraud, a corporation should be viewed as a separate taxable entity. Thus, a captive insurer should be treated as a separate and distinct entity for federal tax purposes and not as the alter ego of its parent or brother-sister unless fraud or sham is found. The question of whether a transaction is a sham is highly factual. If the arrangement is a sham, then the inquiry ends and the payments by a parent and/or brother-sister to the captive insurer are treated as nondeductible reserves and not insurance premiums. Malone &. Hyde, Inc. v. Commissioner, 62 F.3d 835, 839 (6th Cir.1995).

In Ocean Drilling & Exploration Co. v. United States, 24 Cl.Ct. 714 (1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993), the United States Claims Court addressed whether the taxpayer's captive insurance subsidiary was a sham corporation. In concluding that the captive (Mentor Insurance Ltd.) was not a sham, the court stated:

> Several factors contribute to recognizing Mentor as a valid insurance company. The parties that insured with Mentor . . . truly faced hazards. . . . Premiums charged to [the parent] and unrelated parties were based on the commercial rates . . . . The validity of claims was established before payments were made on them. Claims were paid from funds of Mentor that were maintained separately from [the parent's] funds. Mentor's capitalization was adequate, and the policies it entered into were valid and binding. Mentor's business operations were separate from [the parent's]. Cumulatively, these facts indicate that Mentor's existence as an insurance company was valid and not a sham.

Ocean Drilling, 24 Cl.Ct. at 728-29 [footnote omitted].

In determining whether or not the captive insurance company is a sham, courts have examined the capitalization and financial condition of the captive insurer, considering whether the captive is thinly capitalized and weak financially such that the parent would be required to contribute additional capital. In making these findings, courts consider whether the regulator in the locale where the insurance company is incorporated is strict or very lax in its regulation of insurance companies, which would affect the capitalization requirements for the insurance company . The courts also examine the insurance policies entered into between the captive and the parent/brother-sister entities to determine if they are "arms-length" transactions. Malone & Hyde, Inc. v. Commissioner, 62 F. 3d 835 (6th Cir. 1995) (sham corporation found); Humana Inc. v. Commissioner, 881 F. 2d 247, 252-53 (6th Cir. 1989) (no sham found).

2) Reason for formation of captive insurer.

Courts next look to the reason why the captive insurer was formed. If the captive insurance company was created for a valid business purpose, the courts proceed with their analysis. For example, in Humana, supra, the captive insurer was formed because the insurance coverage of the hospitals operated by the parent and its subsidiaries had been canceled. The court found that to be a legitimate business reason for creating a captive insurance company. Humana, 881 F. 2d at 248-49.

3) Consistency with accepted notions of insurance.

The following step in this analysis is to determine whether the arrangement is consistent with commonly accepted notions of insurance so as not to disqualify the payment from being treated as insurance premiums. Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42, 51-52 (1997). The Kidde court considered whether the arrangement fully allocates a risk i.e. "the risk that in the future one of the parties to the agreement will face uncertain and variable claims against it." Id. at 51. The court focused on the "wording of the respective agreements, the methods of establishing premiums, [and] the presentation of claims by claimants" and concluded that the "arrangement ... conforms to commonly accepted notions of insurance when viewed from the perspective of a claimant presenting a claim against Kidde." Id. at 52.

4) Risk shifting.

In accordance with LeGierse, supra, courts then determine whether or not "risk shifting" is present. Risk shifting has been described as involving "the shifting of an identifiable risk of the insured to the insurer." Humana, 881 F.2d at 251. That is, what is the economic consequence of the captive insurance arrangement to the insured party.

In AMERCO, Inc v. Commissioner, 96 T.C. 19 , aff'd 979 F.2d 62 (9th Cir. 1992), the Tax Court stated:

> Basic to any insurance transaction must be risk. An insured faces some hazard; an insurer accepts a premium and agrees to perform some act if or when the loss event occurs. If no risk exists, then insurance cannot be present. "Insurance risk" is required; investment risk is insufficient. If parties structure an apparent insurance transaction so as to effectively eliminate the effect of insurance risk therein, insurance cannot be present.

96 T.C. at 38-39.

The inquiries include the relationship between the brother-sister entities and captive insurer, for example, whether or not the brother-sister entities own stock in the captive insurer. When the insured party incurs a loss, is only the captive insurer affected by the loss or is the economic reality such that only the insured party in reality is affected by the loss. Humana, supra, at 253; M & H. 40. One factor in making such a determination is the existence of indemnity or hold-harmless agreements, loan guarantees or irrevocable letters of credit between the parent or brother or sister to the under-capitalized captive. If such agreements

and guarantees exist, then risk shifting is not present. See Malone & Hyde, Inc. v. Commissioner, 62 F. 3d 835 (6th Cir. 1995); Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1986); Carnation Company v. Commissioner, 640 F.2d 101 (9th Cir. 1981).

5) Risk distribution.

The final step in the analysis utilized by courts in accordance with LeGierse, supra, in considering this issue is whether there is risk distribution. Risk distribution is, generally, poorly defined by the courts. It is accomplished where the risk is distributed among insureds other than the entity that incurred the loss. Ross v. Odom, 401 F.2d 464 (5th Cir. 1968). As the court stated in Kidde,

> Risk distribution occurs when particular risks are combined in a pool with other, independently insured risks. By increasing the total number of independent, randomly occurring risks that a corporation faces (i.e., by placing risks into a larger pool), the corporation benefits from the mathematical concept of the law of large numbers in that the ratio of actual to expected losses tends to approach one. In other words, through risk distribution, insurance companies gain greater confidence that for any particular short-term period, the total amount of claims paid will correlate with the expected cost of those claims and hence correlate with the total amount of premiums collected.

Kidde, supra, at 53. See also, Commissioner of Internal Revenue v. Treganowan, 183 F.2d 288, 291 (2nd Cir.), cert. denied, 340 U.S. 853 (1950).

The court in Clougherty Packing Company v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), explained the principle of risk distribution as follows:

> Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely the receipt of premiums.

811 F.2d at 1300.

If there is a significant amount of insurance of unrelated third parties, court have generally found risk shifting and risk distribution. Your submission indicates

that b% and c% of the total premiums earned by A in Years 3 and 4, respectively, were received from B's or Taxpayer's taxable subsidiaries. Premiums from unrelated third parties (M and N) totaled d% and e% for Year 3 and Year 4 respectively. Thus, the relationship among the parties must be determined, considering factors such as whether the brother-sister subsidiaries have an ownership interest in the captive insurer or in each other. See, e.g., Humana**,** supra, at 256-57.

Courts have found no risk distribution where the parent attempts to insure its risks through a wholly-owned captive subsidiary that does not insure risks apart from its parent. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987) (disallowing deduction where taxpayer paid premium to unrelated insurer, who reinsured risk through taxpayer's wholly-owned subsidiary); Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985) (holding that premiums paid by taxpayer to wholly-owned subsidiary are not deductible)**.**

In cases where the captive insurer accepts risks of unrelated entities, including brother-sister corporations, some courts have held that risk shifting and risk distribution are present, rejecting Rev. Rul. 88-72 and thereby allowing a deduction for premiums paid. See Harper Group v. Commissioner, 979 F.2d 1341 (9th Cir. 1992) (holding that risk shifting and risk distribution are present where captive received 29 to 32 percent of premiums from unrelated parties); Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858 (7th Cir. 1992) (concluding that risk shifting and risk distribution present where captive received 99.75 percent of premiums from unrelated parties).

Where the percentage of insurance for unrelated entities is de minimus, courts have found no risk shifting or risk distribution. See, e.g., . Gulf Oil Corp. v. Commissioner, 89 T.C. 1010 (1987) (explaining that risk distribution not present where captive received 2 percent of risks from unrelated parties), aff'd. on this issue, rev'd. on other issues, 914 F.2d 396 (3rd Cir. 1990); Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1988) (.5 per cent from others).

The United States Court of Appeals for the Sixth Circuit has held that, in "brother-sister" captive arrangements, where the insured and the insurer are subsidiaries of the same parent, all of the elements of the above analysis were satisfied and thus that the premium payments were deductible pursuant to I.R.C. section 162(a) insofar as the premiums were attributable to coverage of the taxpayer's subsidiaries**.** See Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989). Recently, the United States Claims Court, relying upon Humana, held that a brother-sister captive arrangement constituted insurance. Kidde Industries, Inc. v. United States, 40 Fed.Cl. 42 (1997), 1998-1 U.S.T.C. ¶ 50,162. In both Humana and Kidde, the captive in question insured risks only within its related group. Both

courts reasoned that sufficient risk shifting existed with respect to the brother-sister arrangement because a loss incurred by the insured subsidiary did not diminish the assets of that subsidiary when the captive paid the claim. However, in Malone & Hyde, supra, the Sixth Circuit in applying the above analysis to a brother-sister insurance transaction concluded that the arrangement was a sham and thus held that the payments were not deductible as insurance premiums under section 162(a).

The Service's present position concerning the proper federal income tax treatment of captive insurance transactions remains the position set forth in Rev. Ruls. 77-316 and 88-72, and those rulings should be applied in the present case. We recognize, however, that some courts have rejected Rev. Rul. 77-316, concluding that insurance exists: (1) between a parent and a captive when the captive also underwrites substantial unrelated business, and (2) between brother-sister subsidiaries of a common parent. Since both situations appear to exist in the present case, we have made some suggestions, infra, concerning additional factual development and litigation hazards associated with this issue.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

. The facts in this case present both a significant percentage of brother-sister premiums, and a de minimus percentage of premiums from unrelated entities. Assuming that this is true, were a court to apply the rationale of Humana, the premiums at issue attributable to B's or Taxpayer's taxable subsidiaries would be deductible.

.

Although your submission is a good start, we believe that in order to properly respond to your inquiries, more factual development is needed. This is because most of the decisions in this areas turn on the facts in each case.

There are several key areas that need to be explored in greater depth and there are inconsistencies in some of the facts. For example, your submission indicates that there were unrelated insurance premiums. However, your submission also indicates that A is a pure captive insurance company according to the laws of State 1 that define such an entity as insuring the risks of only the parent and affiliated companies. Obviously, if that is true, then A has no unrelated insurance premiums.

The facts as submitted are unclear as to who are the insured entities. This should be explored to determine the relationship among the insureds as well as the third parties (M and N). If the brother-sister insureds and/or third party insureds are interrelated, then a court might find that there is no risk shifting or risk distribution present. All or a portion of the "unrelated risks" in this case should be considered related risks if they are attributable to Taxpayer.

The following items should also be developed to determine whether the position of the Service or the analysis adopted by the courts as described above is met:

1. Parental and/or Brother-Sister Guarantees**.** Although your submissions assumes that there were none, this should be determined. As we have discussed, the existence of parental and/or brother-sister guarantees, hold harmless agreements, letters of credit, etc. would indicate that risk shifting has not occurred. Filings with the state may also be a source for such information.

2. Capitalization**.** While the captive insurer's premium to surplus ratio looks good, (according to your submission, there is approximately a ratio), given the size of the operation involved with assets between $ to $, an actuary might be consulted regarding whether the capitalization is indeed adequate**.**

3. Under regulation. In Humana, a significant consideration was the fact that the captive was governed by a strict regulator, Colorado. We suggest that the regulation of insurance in State I be examined to determine if it is a strict regulator or a weak regulator that would permit significant under-capitalization of the captive, or permit a parent to legally borrow out nearly all of the captive's available cash. If the regulation is minimal, did either B or A take advantage of the latitude allowed by the A's regulator?

4. Unavailability of reasonable priced insurance in the marketplace. In Humana, the court found significant the fact that the taxpayer's present insurance had been canceled and the taxpayer was forced to form a captive insurer. The business reason for the formation of the captive insurer is not clear. You have indicated in your submission that A was formed to take advantage of a tax deduction. However, we suggest that you develop facts about what the entities in question did for insurance coverage prior to the formation of A. What was B doing to handle risks prior to the existence of A? Was L acting as the risk manager for B

running the self insurance reserve and then moved on to run A? If so, an analogy could be made that nothing has really changed**.**

In order to develop these areas, in addition to the above-mentioned documents, we also suggest that an attempt be made to obtain the following information:

a. The insurance contracts and the number of contracts;

b. Does the captive reinsure any risks with an unrelated party? If so,

   1. With whom are the risks reinsured; and

   2. What are the terms of the reinsurance agreement?

   3. What is the amount of the captive's business with unrelated entities compared to the amount of business with related entities? What is the level of its unrelated premium income on an annual basis? Exactly how is unrelated premium from third parties determined?

c. What is the captive's premium to surplus ratio for additional years? Is the captive adequately capitalized? Compare the capitalization of the captive with the amount of risk insured.

d. What are the business reasons behind the creation of this captive? Corporate records may assist in this regard, including corporate minutes, articles of incorporation, and bylaws.

e. What is the precise ownership and business relationship of M and N to the other members of the group?

f. Documents that would show that the corporation is a sham.

g. Is the captive's predominant activity the issuing of insurance contracts?

h. All financial guarantees made by the parent and/or brother-sister subsidiaries regarding A, including hold-harmless agreements, letters of credit, etc.

After these factual areas are developed, we will assist you in determining the answers to your other inquiries. If you have any further questions, please call (202) 622-7870.

DEBORAH A. BUTLER

By: ______________________

JOEL E. HELKE
Chief
Financial Institutions
and Products Branch