INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 7, 2003

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Case Mis No.: TAM-138870-02/CC:FIP:4

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Id.:

Tax Years Involved:

<u>Legend</u>:

Parent:

Foreign Parent:

Operating Subsidiary 1:

Operating Subsidiary 2:
Operating Subsidiary 3:
Operating Subsidiary 4:

Operating Subsidiary 5:
Insurance Subsidiary:
Fronting Company:

Y:

Foreign Country R:

Foreign Country S:

State A:

State B:

State C:

State D:

State E:

State F:

State G:

State H:

State I:

State J:

Year 1:

Year 2:

Year 3:

Year 4:

Year 5:

m:

n:

o:

p:

q:

x:

Cite 1:

Cite 2 :

Cite 3:

Cite 4:

Cite 5:

Cite 6:

Cite 7:

Cite 8:

Cite 9:

Cite 10:

ISSUES

(1) Under the circumstances below, are amounts paid by a parent corporation and its operating subsidiaries to a related foreign captive insurance company for pollution liability coverage deductible as “insurance premiums” under § 162 of the Internal Revenue Code?

(2) Under the circumstances below, are amounts paid by a parent corporation and its operating subsidiaries for their respective workers’ compensation coverages to an unrelated insurance company which, in turn, reinsures the risks with a related foreign captive insurance company, deductible as “insurance premiums” under § 162?

CONCLUSIONS

(1) Under the circumstances below, the amounts paid by a parent corporation and its operating subsidiaries to a related captive insurance company for pollution liability coverage are not deductible as “insurance premiums” under § 162.

(2) Under the circumstances below, the amounts paid by a parent corporation and its operating subsidiaries for workers’ compensation coverage to an unrelated insurance company, which in turn, reinsures the risks with a related foreign captive insurance company, are not deductible as “insurance premiums” under § 162.

FACTS

Parent is a holding company incorporated in State A whose operating subsidiaries are engaged in various manufacturing businesses within the United States. Parent files a consolidated federal income tax return with its subsidiaries. All of the stock of Parent is owned by Foreign Parent which is incorporated in Foreign Country R. Parent, in turn, owns all of the stock of Operating Subsidiaries 1, 2, 3, 4, and 5.

Operating Subsidiary 1 is a State B corporation engaged in the business of m primarily in State C.

Operating Subsidiary 2 was a domestic corporation that operated in State D prior to Year 2. Operating Subsidiary 2 merged into Operating Subsidiary 3 on December 31 of Year 1. For the years under consideration, Operating Subsidiary 2 manufactured n as a division of Operating Subsidiary 3.

Operating Subsidiary 3 is a State A corporation with its headquarters also located in State A. Operating Subsidiary 3 also has facilities in States C, E, F, G, and H. Operating Subsidiary 3 is chiefly engaged as an o.

Operating Subsidiary 4 is a State A corporation with its principal facilities in State I. Operating Subsidiary 4 is engaged in the manufacture of p.

Operating Subsidiary 5 is a State C corporation with its principal business activities in State J. Operating Subsidiary 5 is engaged in the manufacture of q.

Neither Parent nor its operating subsidiaries (collectively, Taxpayers) previously had insurance coverage exclusively devoted to pollution liability. In Year 1, Parent became concerned about the exposure of the operating subsidiaries to pollution liabilities with respect to their respective manufacturing operations and Parent's exposure to pollution liabilities with respect to its ownership of certain real estate used by Operating Subsidiary 1 and Operating Subsidiary 4. In Year 1, Parent commissioned a feasability study to consider the formation of a captive insurance company. The Y Company recommended that the proposed captive insurance company be initially capitalized with $10,000x. On August 3, Year 2, Foreign Parent formed Insurance Subsidiary with a capitalization of $500x under the laws of Foreign County S. It was contemplated that Insurance Subsidiary would have a fiscal year beginning on July 1 and ending on June 30 and, similarly, the pollution policies would be issued on a July 1 to June 30 policy year basis.

Also on August 3 of Year 2, Foreign Parent issued a letter of financial support addressed to Insurance Subsidiary. The letter said:

> This letter will confirm that in the event of insurance claims payable by [Insurance Subsidiary], which are in excess of the paid in share capital and retained earnings of [Insurance Subsidiary], [Foreign Parent] will ensure [Insurance Subsidiary] is in receipt of sufficient funds by way of capital or otherwise to cover such claims, subject to the limits of the liability of the [Insurance Subsidiary] policy(ies).

By its terms, the letter contained no expiration date, nor did Taxpayers provide evidence it was withdrawn or revoked during the years at issue. Foreign Parent furnished to the Foreign Country S insurance authorities a copy of this letter of financial support.

Insurance Subsidiary was issued an insurance license on August 11, Year 2. At various times during the last quarter of Year 2, premiums were paid to Insurance Subsidiary for the first policy year totaling $1,000x. The pollution insurance policies were not formally executed until September 10, Year 4. (Prior to that time the parties assert that they were operating on the basis of draft policy forms.) The premium payments received from Parent and its operating subsidiaries were as follows:

Entity	Amount
Operating Subsidiary 1	$60x
Operating Subsidiary 2	$100x
Operating Subsidiary 3	$620x
Operating Subsidiary 4	$40x
Operating Subsidiary 5	$120x
Parent	$60x
Total	$1,000x

The policies were "claims made" policies with a July 1, Year 2 to June 30, Year 3 policy year. Each of the six policies had its own policy number and declarations page which stated a liability of $10,000x for each pollution incident and $10,000x in the aggregate. The notes to Insurance Subsidiary's Financial Statement prepared by its certified public accountants for its first year state that "[t]he company has written pollution liability coverage policies for each of six related companies with liability limited in each case to $10,000x aggregate and $10,000x for each pollution incident." Another note in Insurance Subsidiary's Financial Statement states that "[Foreign Parent] has guaranteed that sufficient funds will be made available to company [Insurance Subsidiary] in the event that financial support is required in respect to insurance claims." The notes made no mention of the fact that Insurance Subsidiary had not yet been formed as of the purported inception date of the policies, nor that the policies still were not formally executed.

No claims were paid by Insurance Subsidiary for the policy period July 1, Year 2 through June 30, Year 3. With premiums paid to the Insurance Subsidiary in the amount of $1,000x and with its initial capitalization of $500x, after accounting for its expenses/liabilities Insurance Subsidiary's capital and surplus (total shareholder's equity) was approximately $1,500x as of June 30, Year 3.

In Year 3, Parent and its operating subsidiaries entered into insurance contracts with Fronting Company with respect to workers' compensation risks. Effective August 1, Year 3, Fronting Company in turn entered into a reinsurance agreement with Insurance Subsidiary with respect to the underlying workers' compensation risks of Parent and its operating subsidiaries. Under the reinsurance agreement, Insurance Subsidiary received approximately $1,022x in premium income. In addition, for the policy year July 1, Year 3 to June 30, Year 4, Insurance Subsidiary received $1,000x of premiums with respect to the six pollution policies for an aggregate maximum liability of $60,000x for its pollution coverage alone. The $1,000x in premium income with respect to the pollution coverage received from Parent and its operating subsidiaries were as follows:

Entity	Amount
Operating Subsidiary 1	$43x
Operating Subsidiary 2	$63x
Operating Subsidiary 3	$695x
Operating Subsidiary 4	$16x
Operating Subsidiary 5	$112x
Parent	$71x
Total	$1,000x

The notes to Insurance Subsidiary's Financial Statement prepared by its certified public accountants for the year ending June 30, Year 4 state that "[t]he company has written pollution liability insurance policies for each of six related companies with liability limited in each case to $10,000x in aggregate and $10,000x for each pollution incident." No pollution claims were paid by Insurance Subsidiary for the policy period July 1, Year 3 through June 30, Year 4. With respect to the reinsurance of the underlying risks of the workers' compensation risks of Parent and its operating subsidiaries, Insurance Subsidiary reported losses and expenses of approximately $152x. The Financial Statement of Insurance Subsidiary for the year ended June 30, Year 4 shows its capital and surplus (total shareholder's equity) was $2,822x. A note to the Financial Statement under the heading "Pledged Assets" indicates that Insurance Subsidiary has issued a letter of credit [dated November 6, Year 3] in the amount of $1,200x in favor of Fronting Company.

During the year July 1, Year 4 to June 30, Year 5 Insurance Subsidiary again received a total of $1,000x from Parent and the five operating subsidiaries with respect to the six pollution policies. In addition, Insurance Subsidiary received premiums from Fronting Company with respect to its reinsurance of the workers' compensation risks of Parent and the operating subsidiaries. No losses were reported on any of the six pollution liability policies for the July 1, Year 4 to June 30, Year 5 policy year. On the other hand, the reinsurance of workers' compensation risks of Parent and the operating subsidiaries was unprofitable for Insurance Subsidiary. In addition, while the Financial Statement of Insurance Subsidiary for the year ended June 30, Year 5 shows that its capital and surplus grew to $4,028x, a note to the Financial Statement under the heading "Pledged Assets" indicates that the letter of credit in favor of Fronting Company was increased to $1,492x from its previous level of $1,200x.

For Year 2, Year 3 and Year 4, Parent and the operating subsidiaries deducted amounts paid to Insurance Subsidiary as insurance premiums under § 162. The issue in this case is whether the arrangements between Insurance Subsidiary, on the one hand, and Operating Subsidiaries 1 - 5, on the other, constituted insurance for federal income tax purposes.

LAW AND ANALYSIS

Section 162(a) of the Internal Revenue Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred in the taxable year in carrying on any trade or business.

Section 1.162-1(a) of the Income Tax Regulations provides, in part, that among the items
included in business expenses are insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business.

Neither the Code nor the regulations define the terms “insurance” or “insurance contract.”
The United States Supreme Court, however, has explained that in order 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).

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989). 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).

Rev. Rul. 2001-31, 2001-1 C.B. 1348, provides that the Service will no longer assert the economic family theory of Rev. Rul. 77-316, 1977-2 C.B. 53. The ruling makes it clear, however, that the Service will continue to evaluate related party insurance transactions based on existing judicial precedent. In Humana, the United States Court of Appeals for the Sixth Circuit held that arrangements between a parent corporation and its insurance company subsidiary did not constitute insurance for federal income tax purposes. The court also held, however, that arrangements between the insurance company subsidiary and several dozen other subsidiaries of the parent (operating an even larger number of hospitals) qualified as insurance for federal income tax purposes because the requisite risk shifting and risk distribution were present. In Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995), however, the same court concluded that the lack of a business purpose, undercapitalization of the off-shore captive insurance subsidiary, and the existence of related party guarantees established that the substance of the transaction was not insurance.

Amounts paid for liability coverage by operating corporations to an insurance subsidiary of a common parent may be deductible as "insurance premiums" under § 162 of the Internal Revenue Code in appropriate cases. In Rev. Rul. 2002-90, 2002-52 I.R.B. 985, S, a wholly-owned insurance subsidiary of P, directly insured the professional liability risks of 12 operating subsidiaries of its parent. S was adequately capitalized; there were no related guarantees of any kind in favor of S; perhaps most importantly, S and the insured operating subsidiaries conducted themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties. Together, the 12 operating subsidiaries had a significant volume of independent, homogeneous risks. Under the facts presented, the ruling concludes the arrangements between S and each of the 12 operating subsidiaries of S's parent constitute insurance for federal income tax purposes.

In contrast, the facts in the present case show that the arrangements at issue do not constitute insurance for federal income tax purposes, and that amounts paid pursuant to these arrangements are therefore not deductible as insurance premiums under § 162. Although no single fact or factor is determinative, the following discussion explains our conclusion in this case.

Insurance Subsidiary was initially capitalized with an amount equal to one-twentieth of the amount recommended by the independent firm that prepared the Year 1 feasibility study. Specifically, the feasibility study prepared by Y recommended an initial capitalization $10,000x. Insurance Subsidiary was, in fact, initially capitalized with $500x in Year 2. By June 30, Year 4, total shareholder's equity had grown to $2,822x, still less than one-third the initial capitalization that was recommended. In Years 2 through 4, the amount of business written was, at least as high as the amount of business contemplated by the study. Taxpayers point out that the capitalization amount was higher than what was needed to receive its charter under the laws of Foreign Country S, and that the amount was chosen, in part, to avoid running afoul of a specific tax rule in Foreign Country R. We believe, however, that neither the charter requirements of Foreign Country S nor the tax rules of Foreign Country R override the requirement that an entity be adequately capitalized in order to be respected as an insurer for U.S. tax purposes.

Many jurisdictions, including some states in which the operating subsidiaries do business, limit the amount of loss to which an insurer may be exposed on any one risk to ten percent of the insurer's surplus. See, e.g., Cites 1 to 10. In the present case, the insurer's opening surplus in Year 2 was $500x, and the per-incident liability limit for each of the six declaration pages was $10,000x. By June 30, Year 4, total shareholder's equity had grown to $2,822x. A single pollution loss event that reached the $10,000x per incident limit would still exceed the sum of the shareholders equity, premium income and investment income by a substantial amount.

The tax law has no bright line analogous to the 10 percent of surplus rule that applies in some states. It is well established, however, that adequate capitalization is a prerequisite to honoring an arrangement as insurance for federal income tax purposes. Under these facts, we believe the relatively small amount of surplus in relation to the amount potentially at risk in even a single incident demonstrates there was little expectation that Insurance Subsidiary could honor the terms of its policies in the event of a large pollution incident at a single location. Taxpayers argue that a single loss event in excess of $1,500x was unlikely. The cost of a single pollution loss event, however, can easily reach $10,000x, particularly where, as here, hazardous chemicals are involved. We are disinclined to ignore what otherwise appear to be reasonable per-incident limits.

The degree of informality which the parties accorded Insurance Subsidiary also weighs against respecting the arrangements at issue as insurance. As noted above, the Year 2 policies purported to be effective July 1, Year 2, even though Insurance Subsidiary was not formed until August. The Year 2 and Year 3 policies were not formally executed until Year 4. (Taxpayers assert there were oral contracts in the meantime.) The six policies on their face set forth six policy numbers for each year, six per-incident limits, and six aggregate limits, of $10,000x. (Taxpayers assert, however, that these six policies were intended to be administered as though a single $10,000x limit applied.) An August 3, Year 2, letter from the Managing Director and Vice Chairman of Foreign Parent, memorializes a guarantee that Foreign Parent will ensure that Insurance Subsidiary has sufficient funds to pay claims. The June 30, Year 3 financial statements, audited by an international accounting firm, refer to this guarantee. (Taxpayers originally disavowed that letter, later disparaged it as “unenforceable,” and then recharacterized it as akin to a “letter of intent.”) We are not in a position to analyze the consequences of pre-incorporation commitments, oral contracts of insurance, or the limits on parole evidence under the laws of Foreign Country R or Foreign Country S. We believe, however, that in this case the contradiction of multiple legal documents and excessive informality among the parties weigh against respecting the arrangements at issue as insurance.

Finally, the facts of the case demonstrate only limited risk distribution among Parent and the operating subsidiaries as a result of the arrangements at issue. From year to year, approximately two thirds of the premiums received by Insurance Subsidiary with respect to pollution liability came from a single insured -- Operating Subsidiary 3 – which operated a small number of plants, most of which engaged in the same operations and used and stored the same chemicals. Taxpayers argue that Harper Group & Subsidiaries v. Commissioner, 96 T.C. 45 (1991), stands for the proposition that “where a single corporate policyholder pays as much as 71% of the total premium, risk distribution is sufficient to qualify the arrangement as insurance.” Taxpayers’ argument overstates the holding of Harper Group in two important respects. First, in Harper Group, the 71% related not to a single corporate policyholder, but to all related policyholders, including brother-sister corporations. Second, the risks insured in Harper Group were diverse and widespread. Specifically, Harper Group involved an extensive variety of cargo shipments throughout the world by a variety of means and vessels. In contrast, the two thirds of the premiums in the present case represent the pollution liability of a single insured with similar operations in a handful of locations. The remaining third of Insurance Subsidiary’s business is similarly limited to a relatively small number of operations of the remaining five entities. Together with the limited capitalization and informality accorded the arrangement, we do not believe this rises to the level of insurance for federal income tax purposes.

Taxpayers' most recent submission argues that if the arrangements at issue are not deductible as insurance premiums, they are nevertheless deductible as something else, such as "indemnity" or "guaranty" agreements. Taxpayers' submission provides no factual or legal analysis for this assertion, nor does it explain why under the facts of this case the amounts at issue are better characterized as deductible "indemnity" or "guaranty" payments, rather than, for example, nondeductible amounts set aside for self-insurance, or indirect contributions to the capital of Insurance Subsidiary. Moreover, in order to consider this argument, we would need to confront some of the same factors that prevent our concluding the arrangements qualified as insurance: the apparent financial inability to make good on claims that reach the per-incident limit; excessive informality among the parties; contradictions of terms of written contracts. For all the above reasons, we conclude the amounts at issue are not deductible as insurance premiums under § 162.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) provides that it may not be used or cited as precedent.