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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Captive insurance transaction

This Field Service Advice responds to your memorandum dated October 15, 1999. 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 =
Country A =
X =
Y =
Z =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Year 1 =
Year 5 =
Year 7 =
Year 8 =
Year 16 =
Year 19 =
Year 21 =

Year 22 =
Year 23 =
Year 24 =
Year 25 =
Year 26 =
Year 27 =
Year 28 =
Year 36 =
$a = $
$b = $
$c = $
$d = $
$e = $
$f = $
$g = $
$h = $
$i = $
$j = $
$k = $
$l = $
m% = %
n% = %
p% = %
q% = %
r% = %
s% = %
1xx% = %
2yy% = %
aa% = %
bb% = %
cc% = %
dd% = %
ee% = %
ff% = %
gg% = %
hh% = %
ii% = %

ISSUES

Whether the captive insurance transactions at issue are insurance for federal

income tax purposes.

CONCLUSIONS

As set forth, infra, further factual development is necessary.

FACTS

On October 19, 1998, we responded to your request for Field Service Advice concerning whether a series of transactions between Taxpayer and X were insurance for Federal income tax purposes. In accordance with our advice, the revenue agent drafted a Form 886A, "Explanation of Items," which discusses the issues set forth in this case and concludes that the transactions are not insurance. You have requested that we address the agent's conclusions.

The years in issue are Years 25 through 27. In Year 16, Taxpayer organized X, a foreign corporation domiciled in Country A, for the purpose of reinsuring policies which covered the risks of Taxpayer's independently-owned dealers. X continues to be wholly-owned by Taxpayer. Effective Date 1, Year 21, X elected to be treated as a domestic insurance company under I.R.C. § 953(d), and began filing its income tax liability on Taxpayer's consolidated income tax return. X's headquarters were thereafter moved from Country A to the United States, where it shared facilities with Taxpayer's financial division.

In Year 22, X entered into its first two direct insurance policies. The first was a directors' and officers' liability policy (DOLP) which covered Taxpayer on a claims-made basis, and provided "prior acts" coverage for events occurring on or after Date 2, Year 1.[1] The policy was issued on Date 2, Year 22, for a one-year term, and was renewed for terms ending at the close of the calendar year for Years 23 through 25.

On or about Date 3, Year 22, X entered its second direct insurance policy, an occurrence-based comprehensive general liability policy (CGLP) which provided coverage for Taxpayer and Taxpayer's subsidiaries. There were three classifications of coverage under the CGLP: product liability, auto liability, and general liability. Taxpayer paid a premium for the initial CGLP in the amount of $a.

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[1] The term "prior acts" refers to coverage for claims arising from events which occurred before the beginning of the policy period. For claims-made liability policies, prior acts coverage ensures coverage of claims made during the policy period for events which occurred before the policy was in force. See Harvey W. Rubin, Dictionary of Insurance Terms at 253 (Barron's, 1987).

Under the initial CGLP policy, X agreed to provide coverage for events occurring from Date 4, Year 5 through Date 3, Year 23. Thus, as with the DOLP, the CGLP provided retroactive coverage for loss events which had occurred before the policy's effective date. The policy was renewed for terms ending at the close of the calendar year for Years 23 through 27. Product liability constituted most of the expected ultimate liability under the CGLP as of the close of calendar Year 27.

The CGLPs entered into between Year 22 and Year 27 limited X's liability for covering Taxpayer's losses. The premiums paid by Taxpayer and X's limitation of liability with respect to each CGLP are as follows:

COVERAGE PERIOD	PREMIUM	LIMIT OF X's AGGREGATE LIABILITY
Date 4, Year 5 to Date 3, Year 23	$a	$b
Date 5 to Date 6, Year 23	$c	$d
Year 24	$e	$f
Year 25	$g	$h
Year 26	$i	$j
Year 27	$k	$l

Taxpayer also purchased excess of loss policies from unrelated insurers. These policies provided coverage for Taxpayer to the extent that its losses exceeded a certain amount, typically an amount far greater than X's limitation of coverage under the CGLP. Thus, these policies provided coverage to Taxpayer for extraordinarily catastrophic claims.

As indicated in the table above, X's limitation of liability under the initial CGLP was $b. The 18.25 years covered under the initial policy were broken into 17 different periods, each having a separate aggregate limit to liability. Taxpayer has hired an actuary (Z) to perform annual actuarial reviews of its liability exposures for the period Date 7, Year 8 through Date 3, Year 28. Z's reports for Years 24 and 25 reflect that Taxpayer's loss data dating back to Year 5 was used in Z's projection methodologies. This body of relevant experience, coupled with related data gathered from insurance industry sources, enabled Z to estimate Taxpayer's ultimate losses and project the timing of loss payments. Accordingly, Z's reports

contain projections of Taxpayer's ultimate losses and allocated loss adjustment expenses (ALAE).

X's administrative management firm (Y) also developed an anticipated loss and ALAE payment pattern at or about the time that the initial CGLP was formed in Year 22. To do so, Y analyzed Taxpayer's historical loss payment data from Year 7 to Year 19. From these development factors, Y generated an overall expected payment pattern. Y expanded its analysis to show anticipated loss payments from X to Taxpayer on an annual basis for the contract, from Year 22 through Year 36.

You have raised the concern that Taxpayer set X's aggregate liability limit under the CGLPs at a level which Taxpayer knew would be exceeded. In effect, Taxpayer and X knew in advance what X's liabilities would be under the CGLPs. In this regard, the agent contends that Taxpayer's anticipated losses and ALAE range from 1xx% to 2yy% of the CGLP's limit of liability with respect to claims occurring from Date 3, Year 21 onward. The agent further contends that for federal income tax purposes, X has generally claimed deductions attributable to its loss reserves up to the aggregate loss limitation under the policy. See I.R.C. § 832(b)(1)(A), (b)(3), (b)(5) (allowing insurers to reduce premium income by the amount of "losses incurred"). The agent explains that X established annual loss reserves in an amount equal to its maximum liability under the CGLP as a result Y's and Z's projection that Taxpayer's losses for each policy year would exceed X's limitation of liability. For the following reasons, the agent asserts that the CGLPs for the years in issue did not involve sufficient risk transferring to be considered insurance.

The agent argues that the CGLPs appear to be financing transactions, rather than insurance transactions. Taxpayer's premium paid to X will be sufficient to fund the payment of losses covered by the CGLP, up to the policy's aggregate loss limit, as long as X invests the premiums it received at a rate greater than m%, and the anticipated loss payment pattern does not accelerate appreciably. The only exception is the contract effective for Year 24, which requires portfolio earnings of n%. For that contract, the ratio of premium to X's aggregate loss limit is p%. For all other policy years, that ratio has ranged from q% to r%. X's portfolio earnings rate have averaged approximately s%, an amount which exceeds m%, but is slightly less than n%.

As mentioned, the CGLP provides coverage for both Taxpayer and its subsidiaries. In this regard, Taxpayer charges each subsidiary their portion of the premium. This allocation is based on criteria developed by Taxpayer and is subject to periodic modification. For liability coverages the premium breakout between Taxpayer and its subsidiaries is as follows:

Policy Year	Taxpayer	Subsidiaries
Year 25	aa %	dd %
Year 26	bb %	ee %
Year 27	cc %	ff %

Apart from insuring Taxpayer and its subsidiaries, X reinsured the risks of Taxpayer's independently-owned dealers during the years in issue. The agent calculates that the portion of X's premiums earned that are attributable to the risks of these unrelated dealers is gg% for Year 25, hh% for Year 26, and ii% for Year 27. X is adequately capitalized, and Taxpayer has no duty to indemnify parties if X lacks sufficient funds to meet its obligations.

The agent has proposed disallowance of the deductions claimed by Taxpayer and its subsidiaries for insurance premiums paid to X for the taxable Years 25 through 27. You have requested our advice concerning Taxpayer's treatment of the "insurance" premiums paid to X for those years. Although these are captive insurance transactions, the revenue agent has not focused exclusively on the relationship of the parties for the purpose of determining whether the transactions are insurance. See Rev. Rul. 77-316, 1977-2 C.B. 53. As mentioned, the agent also argues that since Taxpayer's losses were almost certain to exceed X's liability limits under the policies, the policies transferred timing and investment risks, rather than true insurance risks. Accordingly, the agent concludes that the transactions should not be treated as insurance for federal income tax purposes.

LAW AND ANALYSIS

Premiums paid for insurance are deductible if directly connected with the taxpayer's trade or business. Treas. Reg. § 1.162-1(a). Although the Internal Revenue Code does not define the term "insurance," courts have generally required that a transaction involve both "risk shifting" (from the insured's perspective) and "risk distribution" (from the insurer's perspective) in order to be characterized as insurance. Helvering v. LeGierse, 312 U.S. 531, 539 (1941); Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 411 (3rd Cir. 1990). Furthermore, the transaction must involve an "insurance risk," and must involve "insurance in a commonly accepted sense." AMERCO, Inc. v. Commissioner, 96 T.C. 19, 38, aff'd. 979 F.2d 162 (9th Cir. 1992). The deductibility of the amounts paid by Taxpayer to X, will depend upon whether the policies are insurance transactions.

In our prior advice, we explained to you the Service's current position concerning captive insurance. With few exceptions, discussed infra, in "Case Development, Hazards and Other Considerations," (case development section) the agent's

proposed conclusions reflect a proper understanding of this position. In addition, we explained to you in our prior advice the Service's current position with respect to risk distribution. The agent's proposed conclusions also reflect a proper understanding of this position.

In our prior advice, we also addressed whether Taxpayer and its subsidiaries transferred insurance risk to X, without regard to the ownership relationship of the parties. The agent has concluded that, because X's maximum liability to Taxpayer and its subsidiaries under the CGLP is far less than the actual losses that Taxpayer and its subsidiaries expect to incur, Taxpayer and its subsidiaries did not transfer insurance risk to X. In particular, the agent has concluded that, because Taxpayer is nearly certain that X will pay losses equal to its maximum liability under the CGLP, the contract involves timing and investment risk, rather than insurance risk. Although the agent's conclusions are consistent with our prior advice, no court has addressed this issue. Accordingly, we have set forth additional considerations, infra, in the case development section.

Lastly, in our prior advice, we considered whether any of the transactions at issue could be considered shams. We recommended additional factual development with respect to that issue. After we issued our prior advice, the Tax Court released its opinion in United Parcel Service of America v. Commissioner, T.C. Memo. 1999-268 (UPS). The court in UPS treated as a sham a seemingly valid insurance transaction on the basis that the transaction was tax-motivated and resulted in an impermissible assignment of income.

The taxpayer in UPS was a shipper which offered protection to its customers for lost or damaged packages. UPS charged its customers a fee for this service, generating a significant profit; approximately 30% of the amount charged was actually devoted to paying claims, while UPS retained the remainder. UPS then decided to transfer these profits offshore. It accomplished this by "insuring" the risks of its customers through a commercial insurance company, which then reinsured the risks through a newly-formed Bermuda reinsurance company affiliated with UPS.[2] Thus, the profits were shifted from UPS to the commercial insurer (which took a small percentage), and then to UPS' offshore subsidiary. After this transaction, UPS did not include any of the profits in its income. The commercial insurer was liable to UPS's customers if the offshore reinsurance subsidiary lacked sufficient funds to cover losses; therefore, some minimal risk had been shifted.

The Tax Court concluded that the entire transaction was a tax-motivated sham and

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[2] UPS did not own the reinsurer; rather, UPS and the reinsurer were controlled by common shareholders.

an impermissible assignment of income. Thus, the court concluded that none of the amounts paid to the commercial insurer were for insurance, although the court acknowledged that some "theoretical" risk had been transferred. In this regard, the court specifically discussed the vastly inflated price paid by UPS to the commercial insurer, relative to the remote risk transferred. The court explained that the arrangement did not sufficiently reduce UPS' financial exposure to be regarded as having economic substance.

In the present case, due to X's limitation of liability, the CGLPs appear to involve minimal risk shifting and considerable tax benefits. In light of the court's opinion in UPS, the Service in this case could challenge Taxpayer's characterization of the CGLPs as insurance on the basis that the CGLPs were primarily tax-motivated and lacked economic substance. We have set forth additional considerations in this regard, infra, in the case development section.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In our prior advice, we explained that under the case law applicable to captive insurance transactions, a court in this case will view the amount of unrelated business assumed by X as a significant factor in determining whether X insured Taxpayer and its subsidiaries. [redacted]

The strongest argument raised by the agent is that risk shifting is not present with respect to the CGLP because the losses of Taxpayer and its subsidiaries are certain to exceed the limitation of liability under the contract. No court has addressed this issue. As mentioned in our prior advice, a court will likely assume that an agreement to provide coverage for events which have not yet occurred involves shifting of risk. Nevertheless, the proposed Form 886-A correctly explains that the principles underlying the agent's conclusions therein have been recognized within the insurance industry, which will not treat as insurance any purported reinsurance transaction that appears to transfer insurance risk, but merely transfers timing and investment risk. American Inst. of Certified Public Accountants, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, Financial Accounting Standards No. 113 (1992). [redacted]

[redacted]

The difficulty in this case will be quantifying the amount of risk that must be shifted to a putative insurer in order to qualify as insurance for tax purposes. On pp. 10-20 of the proposed Form 886-A, the agent discusses extensively the potential cash flows from the transactions. The schedule appearing on p. 17 of the proposed Form 886-A reflects potential losses on the relevant contract only where the payments are accelerated by two years. Those losses would be timing losses, and not underwriting losses. On pp. 18 and 19 of the proposed Form 886-A, the agent explains why there is no reasonable possibility of a significant underwriting loss on the transaction.

The term "no reasonable possibility of an underwriting loss" is not self-explanatory. In the context of a policy where the insured pays a premium to cover a layer of losses, we believe that standard means that there is a reasonable possibility that the insurer will have to pay out in losses and expenses, more than the premiums it receives, plus the investment income it can expect to have earned on those premiums. [redacted]

We also conclude that the Service should frame this particular issue in the context of the Tax Court's opinion in UPS. If the Service in this case, [redacted], can establish that there is little or no possibility that X will incur an underwriting loss under the CGLPs, the court will most likely call into question whether the transaction was tax-motivated and lacked economic substance. In this regard, we doubt that Taxpayer entered into the CGLPs for the same reasons that parties typically enter into insurance transactions, i.e., to shift, for a sum certain, the costs associated with potential future loss events. As mentioned in our previous advice, the transactions raise the following questions:

[redacted]

[redacted]

In addition to the agent's concluding that there was no reasonable possibility that X could suffer a loss under the arrangement, on p. 19 of the proposed Form 886-A, the agent notes that Taxpayer was required to keep certain records of occurrences which are likely to cause a payment under the policy and to forward summaries of those records to the X at the start of each year. The agent points out that section IX of the CGLP provides that X "shall indemnify the Insured for payments of Ultimate Net Loss as soon as practicable after receipt of such report to the extent that amounts of Ultimate Net Loss paid to date have not been indemnified by [X]." The agent then concludes that claims or occurrences of which Taxpayer might be aware need not be subject to reimbursement until January of the following year, and implies strongly that the delay in payment will cause the contract not to qualify as an insurance contract.

We agree that contractual provisions in a reinsurance contract which delay timely reimbursement to the ceding insurer can preclude the contract from shifting a risk of loss. If a purported insurer is permitted to retain the insured's funds long enough, it will be able to generate enough investment earnings to eliminate the possibility that it will incur a financial loss on the transaction. It seems unlikely in this case that Taxpayer's holding X's funds until the beginning of the year succeeding the year of loss will guarantee that any potential loss that otherwise might be inherent in the arrangement will be eliminated. [redacted]

Lastly, we recommend that the term "Duh" be removed from p. 57 of the agent's proposed Form 886-A.

Please call if you have any further questions.

Deborah A. Butler
Assistant Chief Counsel (Field Service)
By: JOEL E. HELKE, Chief
Financial Institutions and Products Branch