INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

8/6/01

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CASE MIS No.: TAM-104497-00/CC:FIP:B4

Taxpayers Name:

Taxpayer's Address:

Taxpayer's Id. No.:
Tax Year Involved:

LEGEND:

Parent =

Insurance Subsidiary =

Reinsurer =

State C =

State D =

State E =

State F =

Date A =

Date B =

Date C =

Date D =

Month E	=
Date F	=
Year 1	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
r	=
s	=
t	=
u	=
v	=
w	=
x	=
y	=
z	=
Service	=

ISSUE

Whether Insurance Subsidiary, which provided coverage only to its sibling operating subsidiaries, is an insurance company for federal income tax purposes subject to the provisions of Part II of subchapter L of the Internal Revenue Code?

CONCLUSION

Under the facts described below, Insurance Subsidiary is an insurance company subject to the provisions of Part II of subchapter L of the Code.

FACTS

Parent is a State C company whose approximately v operating subsidiaries are engaged in operating Service facilities. Parent's group has in excess of w employees at any one time and, due to high turnover, there are about x employees in any particular year. Most of the operating subsidiaries do business in State C; a small number do business in State E.

Insurance Subsidiary was originally incorporated on Date A, Year 1, under the laws of State D to act as a reinsurer of the workers' compensation risks of its operating sibling corporations. Parent, its operating subsidiaries, and Insurance Subsidiary are included in the consolidated tax return of Parent. Most of the operating subsidiaries do business in State C; a small number do business in State E.

Prior to the formation of Insurance Subsidiary, members of Parent's group obtained workers' compensation insurance from an unrelated direct writing insurance carrier. However, when the workers' compensation market became volatile, available coverage unpredictable and premium costs inconsistent, especially in State C, Parent considered a number of alternatives to meeting the group's workers' compensation coverage needs and established Insurance Subsidiary in State D.

While domiciled in State D, Insurance Subsidiary's license only allowed it to provide reinsurance to the group's workers' compensation program. For the period ending on December 31, Year 8, the primary insurance carrier was one or more domestic fronting companies, which bore all reporting, compliance with Department of Insurance, and rate filing requirements.[1] As reinsurer, Insurance Subsidiary provided workers' compensation coverage with respect to more than w employees of the operating subsidiaries.[2]

In Month E, Year 8, Insurance Subsidiary was redomesticated in State C. After it became a fully licensed State C insurance company, Subsidiary began writing insurance policies for the State C operating subsidiaries within the group. Insurance Subsidiary has not assumed any new reinsurance business for accident years subsequent to December 31, Year 8. Instead, Insurance Subsidiary directly writes all of the insurance business that it provides, and it reinsures a portion of all of its insurance policies with Reinsurer, a State F corporation, which is an unrelated international reinsurance company. During the first six months of Year 9, Insurance Subsidiary

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[1] The single tax year which is the subject of this technical advice memorandum began on Date C, Year 8 and ended on Date D, Year 9.

[2] Parent has no employees as all of its functions are performed by employees in a "headquarters" subsidiary.

reinsured the excess of loss over the first $500,000 net loss per occurrence for workers' compensation and employers' liability policies it wrote, subject to maximum limits. Insurance Subsidiary has paid State C premium taxes since its redomestication and before that, paid State D premium taxes on reinsurance.

Insurance Subsidiary's premium to surplus ratio as of the last day of the fiscal year under consideration in this request for technical advice was y and its capitalization was at least $z. Neither Parent nor its affiliates are obligated to contribute capital to Insurance Subsidiary in the event the company becomes financially weak and cannot meet its obligations. Further, there are no hold harmless agreements under which Parent would not pursue claims against a fronting company if Insurance Subsidiary defaulted on its obligations as reinsurer.

Insurance Subsidiary issues each affiliate of Parent a separate policy, and each affiliate separately records its monthly actual payroll. In order to determine premiums for insurance business that it writes directly, Insurance Subsidiary, submits actuarially determined rates for approval to the State C Department of Insurance. These approved rates are applied to the individual policyholders with adjustments to reflect the State C Workers' Compensation Rating Bureau modification factor and any other risk modification factors allowable under Insurance Subsidiary's approved rating plan. The reinsurance premiums paid by Insurance Subsidiary are established by Reinsurer as a percentage of gross written premiums. Insurance Subsidiary keeps its approved rating filing plan with the state in which it is located.

Prior to becoming a direct writer fully licensed in State C, Insurance Subsidiary had no employees and all management, administrative and claims management, and claims servicing were contracted with third party administrators. After becoming a direct writer, Insurance Subsidiary began hiring employees. Since Date F, Year 9, Insurance Subsidiary has employed a President and Chief Executive Officer, a Secretary and Chief Financial Officer, and a Vice President and Chief Operating Officer who have overall responsibility for insurance operations including underwriting and claims administration.[3] The only business conducted by Insurance Subsidiary is providing workers' compensation coverage.

Reserves for business written and assumed by Insurance Subsidiary are based upon an independent actuarial analysis. Claim and loss adjustment reserves for business insured or reinsured are based upon a review by a third party actuary at the end of each calendar year. For the year at issue, Insurance Subsidiary's premium income was $r, losses paid were $s, unpaid loss reserves increased by $t, and premiums paid for reinsurance totaled $u.

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[3] Day-to-day claims management, loss control services, information services, accounting, personnel and reporting functions along with secretarial support were performed by third party administrators. In Year 10, Insurance Subsidiary hired a manager of accounting and financial reporting and dispensed with the third party contractors who used to keep its books and records. Since Year 10 it has, and continues to maintain, its own books and records. In Year 11, Insurance Subsidiary hired a claims manager for claims oversight.

LAW AND ANALYSIS

Section 831(a) of the Code provides that taxes, as computed in § 11, are imposed for each taxable year on the taxable income of each insurance company other than a life insurance company. Section 832(a) provides that taxable income means the gross income as defined in § 832(b)(1) less deductions allowed by § 832(c). Under § 832(b)(1)(A), gross income includes the combined gross amount earned during the taxable year from investment income and from underwriting income computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. Section 832(b)(3) defines "underwriting income" as premiums earned on insurance contracts during the taxable year less losses and expenses incurred.

Section 1.831-3(a) of the regulations provides that for purposes of §§ 831 and 832 of the Code, the term "insurance companies" means only those companies that qualify as insurance companies under the definition in former § 1.801-1(b) (now § 1.801-3(a)(1) of the regulations).

Section 1.801-3(a)(1) of the regulations provides that the term "insurance company" means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 1.801-3(a)(1) further provides that though the company's name, charter powers, and subjection to state insurance laws are significant in determining the business that a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year that determines whether the company is taxable as an insurance company under the Code. See also, Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932) (to the same effect as the regulation).

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The accepted definition of "insurance" for federal income tax purposes relates back to Helvering v. LeGierse, 312 U.S. 531, 539 (1941), in which the Supreme Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing."[4] Case law has defined "insurance" as "involv[ing] a contract, whereby for adequate consideration, one party undertakes to indemnify another against a loss arising from certain specified contingencies or perils ... [I]t is the contractual security against possible anticipated loss." See Epmeier v. United States, 199 F.2d 508, 509-510 (7th Cir. 1952). In addition, the risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F. 2d 1190, 1193 (7th Cir.), cert. denied, 439 U.S.

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[4] The incoming request for technical advice contained a discussion of Rev. Rul. 77-316, 1977-2 C.B. 53, which concluded that there is no economic shifting or distributing of risks of loss to the extent the insured and insurer represented one economic family. Rev. Rul. 2001-31, 2001-26 I.R.B. 1348, explains that the Internal Revenue Service will no longer raise the economic family theory in addressing whether captive insurance transactions constitute valid insurance.

835 (1978).

Risk shifting occurs where a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer. If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance payment. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

Early case law established the principle that reserves for losses held in segregated funds or revocable trusts are a form of self-insurance and are not deductible as insurance reserves. While funds established by an operating business company may be similar in purpose to the reserves of insurance companies, the reserves of insurance companies are deductible under Code sections that do not apply to non-insurance companies. Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930). There has been considerable case law involving the use of related corporations to achieve a result parallel to that of the situation in Spring Canyon Coal Co. In addressing whether a party may insure its parent company, courts have held that there is not sufficient risk shifting to constitute "insurance" for federal income tax purposes where the related party insures only its parent (or its parent's other (non-insurance) subsidiaries), e.g., Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981); Clougherty, supra. In contrast, both the United States Court of Appeals for the Sixth Circuit and the United States Court of Federal Claims held that under similar facts payments to a captive insurer by its sibling subsidiaries were deductible as insurance premiums. Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989); Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42 (1997).

In Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995), the Sixth Circuit applied Humana to a brother-sister insurance transaction and concluded that the captive insurer was a sham, and the payments at issue were therefore not deductible as insurance premiums. In Malone, the taxpayer and its operating subsidiaries purchased insurance from a commercial insurer, which then reinsured a significant portion of the premiums received from the taxpayer, and paid the remainder to the captive as a reinsurance premium. The taxpayer claimed deductions for the insurance premiums paid to the commercial insurer. In determining that the captive company was a sham, the court in Malone noted that the parent "propped up" the captive by guaranteeing its performance, the captive was thinly capitalized, and the captive was loosely regulated by the locale in which it was incorporated (Bermuda). Id. at 840.

Other factors to consider in determining whether a transaction will be treated as insurance for federal income tax purposes include whether a captive insurance transaction is a sham include whether the captive's business operations were kept separate from its parent's. Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728-729 (1991), aff'd. 988 F. 2d 1135 (Fed. Cir. 1993). The essence of whether an arrangement is insurance depends upon whether the company's assumption of the risk of loss "is part of a general scheme to distribute actual losses among a large group of persons bearing somewhat similar risks." William R. Vance, Handbook on the Law of Insurance, (pages 1 and 2) 3rd ed. 1951. Risk distribution has been further explained as incorporating 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 a premium 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. See Clougherty Packing Co., 811 F.2d at 1300.

In the present case, there were no parental or related party guarantees (in any form) propping up Insurance Subsidiary. The company was adequately capitalized and its premium to surplus ratio was strong. The reason for the formation of the company was due, at least in part, to significant disruptions in the price to be paid to unrelated insurers for workers' compensation coverage in State C. Further, Insurance Subsidiary for the greater portion of the fiscal year under consideration was a fully regulated (non-captive) domestic insurance company under the laws of State C. The company issued to each of the operating subsidiaries a separate policy and maintained separate records apart from its affiliates. While it was a company regulated under State C law, the company hired a number of officers/employees to further its insurance business and subsequently has continued to add more employees to conduct its insurance business, which we understand is its sole business. Finally, Insurance Subsidiary assumed the workers' compensation risks from approximately v operating subsidiaries (employing in excess of w employees) and distributed this large number of homogeneous, independent risks among its insureds. To some extent Insurance Subsidiary reinsured those risks with a large unrelated insurance company. Accordingly, for the year at issue, we conclude that Insurance Subsidiary is an insurance company subject to the provisions of Part II of subchapter L of the Code.

CAVEAT(S)

No opinion is expressed concerning the application of regulations under § 1502 to the entities or transactions at issue in this case.

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