September 27, 2005

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Office of Associate Chief Counsel
CC:PA:LPD:PR (Notice 2005-49)
Room 5203 – Internal Revenue Service
P.O. Box 7604
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Washington, DC 20044

RE: Request for Comments – Notice 2005-49

The following comments are submitted on behalf of the Captive Insurance Companies Association (CICA), a trade association representing the captive insurance industry. CICA would like to thank the Internal Revenue Service (hereafter called "Service") and Treasury Department for requesting comments on whether certain arrangements constitute insurance for federal income tax purposes and for allowing those in the captive insurance industry an opportunity to respond prior to the issuance of rules or regulations.

We also believe it is appropriate to point out that tax considerations are not the sole determinant of whether or not a captive arrangement constitutes insurance, and we hope the Service and Treasury will recognize that captives are generally formed for commercial purposes to support the overall financial goals of the organizing entity.

<u>CICA Background:</u>

CICA was founded in 1972 and is the only trade association for captive insurance companies that has no jurisdictional or commercial ties.

CICA members come from a wide range of industries. CICA members are domiciled throughout the world, with the highest number domiciled in Vermont, Hawaii, Bermuda, the Cayman Islands and the British Virgin Islands. These captives most commonly write workers' compensation and property/casualty lines, but have also diversified into areas such as product liability and employee benefits.

As part of the process of developing the comments shown below, CICA worked collaboratively with other trade associations representing captive insurance companies from specific domiciles, most notably the Vermont Captive Insurance Association (VCIA). In addition, CICA has worked collaboratively with the following domicile based captive insurance associations:

- Arizona Captive Insurance Association (AZCIA),
- South Carolina Captive Insurance Association (SCCIA),
- Captive Insurance Council – District of Columbia (CIC-DC),

- Bermuda Insurance Managers Association (BIMA),
- Insurance Managers Association of Cayman (IMAC),
- Nevada Captive Insurance Association (NCIA), and
- Hawaii Captive Insurance Association (HCIA).

Both CICA and the Vermont Captive Insurance Association established formal task forces to develop comments in response to Notice 2005-49. Although each organization developed its own set of comments, they have reached substantially the same conclusions. Hence, we are confident that we speak with credibility for the captive insurance industry.

Issues

The Service asked for comment on four separate issues:

- The factors to be taken into account in determining whether a cell captive arrangement constitutes insurance and, if so, the mechanics of any applicable federal tax elections,

- Circumstances under which the qualification of an arrangement between related parties as insurance may be affected by a loan back of amounts paid as "premiums",

- The relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance, and

- Federal income tax issues raised by transactions involving finite risk.

Comments

CICA herewith submits its comments to each of those issues:

I. The factors to be taken into account in determining whether a cell captive arrangement constitutes insurance and, if so, the mechanics of any applicable federal tax elections:

We understand this request for comments to apply without geographic restriction to entities that are licensed as insurance companies under the laws of a U.S. state, territory, the District of Columbia or a foreign jurisdiction. The comments below are intended to apply to cell captives formed in both domestic and foreign domiciles that have enacted cell captive statutes. We acknowledge that these statutes vary, sometimes significantly, and that such variations may impact the proper federal income tax characterization of a particular cell captive arrangement. Similarly, cell captives themselves differ considerably, depending on their constitutional documents, location of their owners and numerous other factors. Accordingly, the comments below are necessarily in the nature of general precepts rather than detailed categorization rules.

Summary of Recommendations

1. The same factors currently considered to determine whether a non-cell captive arrangement constitutes insurance for federal tax purposes also should be used in

analyzing the proper tax status of a cell captive arrangement. Thus, we believe that existing tax authorities, including relevant case law and IRS pronouncements, should be applied to the facts and circumstances of the particular cell captive structure being reviewed in order to ascertain whether the arrangement satisfies the prerequisites of insurance tax treatment

2. Testing for presence or absence of insurance for federal tax purposes should be performed on a cell-by-cell rather than a cell company-wide basis. This approach is consistent with tax recognition of the structural form that the taxpayer has voluntarily selected by incorporating the captive under a cell statute specifically designed to prevent distribution of risk exposures by legally segregating assets and liabilities on a cell-by-cell basis.

3. Federal tax consequences of elections requiring a taxpayer to enter into a closing agreement with the IRS, such as the elections of qualifying foreign insurance companies to be treated as domestic corporations for federal tax purposes under §§ 953(c)(3)(C) and 953(d) of the Internal Revenue Code, should be specified in the pertinent closing agreement. The "default" rule, absent unusual circumstances, for other tax elections not involving a closing agreement (e.g., the election under § 831(b) regarding exemption of underwriting income) should be that elections apply on a company-wide basis.

Description of Cell Companies

The term "cell company" generally describes an arrangement whereby a commercial enterprise is statutorily enabled in its jurisdiction of registration to establish and maintain one or more legally separate, segregated "accounts" in some jurisdictions referred to as "cells" or "protected cells") with respect to a particular participant (e.g., Participant A's risk exposures being funded in Cell A). The cell usually is funded by a combination of capital contributed to Cell A by Participant A and by actuarially determined premiums paid into Cell A by Participant A. The cell company pays claims on behalf of Cell A covered under the policies issued by the cell company on behalf of Cell A exclusively from loss reserves or other assets solely attributable to Cell A. These arrangements typically contemplate a mechanism for Participant A eventually to recover any residual funds in Cell A that exceed the amount its insurance claims and loss costs.

The operative statute of the company's domicile provides that Participant A has no recourse for the satisfaction of its insurance or other claims beyond those assets that are held in Cell A, and that the funds in Cell A are protected against being used to satisfy liabilities of the cell company itself or its other cells to non-Cell A policyholders or creditors. In addition, the statutory structure governing the cell company generally specifically provides that the funds in Cell A are to be held for the benefit of Participant A in the event of the insolvency of the cell company itself or the insolvency of another cell.

Cell companies can be established in a variety of locations. Many foreign jurisdictions and U.S. states have enacted statutes that provide for the formation and operation of cell companies, which include specific statutory provisions regarding the protection of the assets of a cell from claims and liabilities of other policyholders or creditors. The statutes authorizing the establishment of cell companies usually state that the cell company is a single juridical or legal person irrespective of the number of cells its board of directors may

choose to create. Some jurisdictions provide for the cells to be incorporated or to take any legal form of organization permitted by the domicile's statutes.

Cell programs are not limited to companies that conduct business using protected cells authorized by statute. Before the enactment of legislation authorizing formation of cell companies, segregated accounts were created and operated through contractual arrangements, often backed by bank or other third party financial guarantees, between the captive and its participants. As a result, the tax questions applicable to statutory cell programs are also relevant to taxation of contractual cell-type programs

The specific arrangements for participation in a cell company can vary considerably. The mutual rights and obligations of the cell company and a participant may be set forth in: (i) the corporate charter (e.g., articles of incorporation), bylaws or other organizing documents of the cell company that provide for participation through issuance of preferred (usually non-voting) shares; (ii) a participation contract; (iii) the provisions of the insurance or reinsurance policy issued on behalf of the cell by the cell company; or (iv) a combination of (i) through (iii). The common factor in all these arrangements is the attempted segregation of the assets and liabilities within a particular cell, via statute or contract, from the assets and liabilities of the cell company itself, which in some jurisdictions is called the "core capital" or "general account" (often evidenced by issuance of voting common shares) and those of other cells.

Discussion

1. Analyze presence or absence of insurance under current tax authorities

The existing body of law on the proper indicia of insurance for federal tax purposes, developed judicially and administratively over the past three decades, is fully adequate to analyze the federal tax status of any captive insurance arrangement, whether or not it involves a cell program. Specifically, each of the attributes of insurance enunciated in the case law and revenue rulings, including the use of either the unrelated risk or brother/sister risk methods to find presence of insurance, can be applied in a cell company context

In our view, the tax consequences of a cell arrangement should be ascertained in the same manner as any other captive arrangement: is adequate risk distribution and risk transfer present, and taking all relevant facts and circumstances into account, do any other factors present negate insurance tax treatment? This analysis must take into account a variety of factors bearing on the legal relationship among the participant, the cell company, and any other parties insured by the company, including: (i) relevant state or foreign laws; (ii) the company's articles of incorporation, bylaws and other governing documents; (iii) shareholder, member or participation agreements; and (iv) the terms of insurance or reinsurance contracts and policies issued by the captive to its policyholders. Given the broad variety of existing cell captive arrangements and the prospects for development of new cell programs, we advocate a facts and circumstances approach to testing the status of cell companies, which is informed by a few general principles as outlined below. We believe that the exercise of judgment in a case-by-case process is more reflective of the complex state of risk finance than promulgating rigid rules which become inadequate to address new scenarios over time.

2. Test for insurance on a cell-by-cell rather than company-wide basis

The general rule for insurance company status set forth in Section 831(c) applies to a cell company. Thus, the characterization of the cell company as an insurance company for federal tax purposes depends on whether the majority of its business is derived from contracts that satisfy the relevant tests for insurance or reinsurance, including the requisite risk shifting and risk distribution.

Given that segregation of risk exposures is the underlying purpose for creating cell companies, an analysis of risk shifting and risk distribution should be done individually with respect to each cell. Cell "walls" should be respected when testing for risk shifting and risk distribution. In support of this principle, when Congress enacted Section 512(b)(17) in 1996, the pertinent legislative history specifically noted that: "...if the CFC [controlled foreign corporation] serves as a vehicle for the separate funding by each shareholder of its risks or liabilities for claims, without any pooling ..., allocations that fairly reflect such arrangement will be respected for purposes of applying the look-through [taxable income imputation] rule." See H. Rept. No. 104-586, pt. 2, at 138 (1996). Consistent with the foregoing, binding contractual arrangements should be taken into account when risk distribution is being measured, including contracts between cells and, if the company's core capital is not otherwise at risk by domicile statute or regulation to prevent cell insolvency, contracts that put the cell company's core capital at risk should also be viewed as compliant. For example, if a well -funded cell contractually provides stop loss protection to its companion cells, which insure diverse risks of unrelated cell participants, then this pooling of risk should be taken into account when determining the level of risk distribution present.

In sum, the "over 50% test" of Section 831(c) should be applied to a cell company program in an equitable manner, to take into account both the number of cells carrying on an insurance business, and the relative size of the cells, with relative size determined by a commercially reasonable measure such as each cell's net retained premium.

3. Where possible include the tax consequences of elections in the closing agreement

Given the multitude of potential factual scenarios involving cell captive arrangements, many of which are today unanticipated and perhaps will derive from future laws to be enacted by captive domiciles, the better course for all parties is to maintain the flexibility needed to address particular situations as they arise. Accordingly, if an election requires the taxpayer to enter into a closing agreement with the IRS, we believe that document is best suited to describe the appropriate tax consequences of the particular election. For example, closing agreements pertinent to the elections of qualifying foreign insurance companies to be treated as domestic corporations for federal tax purposes under Sections 953(c)(3)(C) and 953(d) would specify the application of the election and any restrictions or limitations imposed on the taxpayer with respect to the election

For tax elections not involving a closing agreement (e.g., the election under Section 831(b) regarding exemption of underwriting income) absent special circumstances

the election should-apply on a company-wide basis. A discussion of the proper characterization of a cell captive as a single taxpayer rather than each cell's classification as a separate taxpayer is beyond the scope of the taxpayer input requested in Notice 2005-49. Nonetheless, we note in passing that both the law of the cell captive domicile and the weight of existing tax authority dealing with regulated investment companies, see, e.g., Union Trusteed Funds, Inc. v. Com'r, 8 T.C. 1133, acq. 1947-2 C.B. 4; Rev. Rul. 56-246, 1956-1 C.B. 316, [both prior to enactment of Section 851(g)] and life insurance "separate accounts" under state law, see, e.g., Rev. Rul. 74-4, 1974-1 C.B. 51; TAM 9807001, Oct. 28, 1997, militate toward the single taxpayer result. To facilitate administration of the tax law and to provide more certainty for taxpayers, we support this general rule; a tax election that does not involve a closing agreement should apply to a cell company on a company-wide basis.

Closing Comment

Because of the wide variety and inherent complexity of cell company arrangements, we do not believe that it is feasible for the IRS to develop comprehensive, uniform rules for the tax treatment of such structures beyond these basic recommendations. Accordingly, we encourage the IRS not to take general positions on other aspects of the federal tax treatment of cell companies or their participants through the issuance of a revenue ruling or other statements binding on revenue agents. Any revenue rulings or expansive pronouncements of an IRS position necessarily would apply only to the simplest program structures, and as such would have very limited utility. If general guidance on cell company taxation is desirable, we believe it will best be developed through non-precedential private letter rulings focused on specific fact patterns and situations.

II. *Circumstances under which the qualification of an arrangement between related parties as insurance may be affected by a loan back of amounts paid as "premiums":*

Summary of Recommendations

We believe that the Service should take a "facts and circumstances" approach to determining the effect, if any, of an insurance subsidiary lending money to its affiliates. The Service should maintain flexibility and should not establish a rule that an otherwise valid insurance arrangement is automatically invalidated when the insurance subsidiary loans some or all its funds to an affiliate. This seems consistent with current Service policy, because in 2001, the Service generally adopted a "facts and circumstances" approach and abandoned its prior absolute prohibition of related party insurance.

Generally an arrangement must have risk shifting and risk distribution in order to qualify as insurance. Once these elements are present, the insurance arrangement has been established. The insurance company's investment decisions are completely independent of establishing risk shifting and risk distribution. Only where the insurance company's investments so compromise its ability to function as an insurance company, can its investments undermine the validity of the insurance arrangement.

In evaluating whether an insurance company's investments have undermined the insurance arrangement, the Service should consider four factors:

(1) Whether the loans represent bona fide indebtedness, which is enforceable by their terms and which contains commercially reasonable terms;

(2) Whether the loans are permitted by the statutes or regulatory authorities of the insurance company's domicile;

(3) Whether the timely repayment of the indebtedness, together in the insurance company's other resources, permits the insurance company to meet its anticipated liquidity needs; and

(4) Whether, taking into account the solvency of, and security (if any) provided by, the debtor, it is commercially reasonable to expect the loans to be repaid in accordance with their terms.

If these factors are present, then the investments of the captive have not invalided the insurance arrangement, whether or not the loans are to a related or unrelated party and whether or not they are to an insured. If some of these factors are not present, in whole or in part, then the insurance arrangement may or may not be undermined, depending on the precise facts and circumstances.

Background on Insurance for Federal Income Tax Purposes

To understand our recommendations, it is appropriate to review the evolution of the Service's approach to related party insurance. When a taxpayer purchases insurance, it is generally deductible as an ordinary and necessary business expense for Federal income tax purposes. Treas. Reg. § 1.162-1(a). If, instead, a taxpayer "self-insures" that risk, no deduction is allowable unless, and until, a loss is incurred. When an operating company purchases insurance from its affiliate, the question has arisen whether the premiums are insurance for Federal income tax purposes. Numerous court cases and Revenue Rulings define insurance for Federal income tax purposes, many of them in the context of related party insurance arrangements. These authorities almost uniformly require that in order for an arrangement to constitute insurance, it must involve both "risk shifting"[1] and "risk distribution."[2] Risk shifting means that an insurance risk must be transferred from the insured to the insurer. Risk distribution means that the insurer assumes a sufficient number of risks, so that, when all the risks are pooled, the law of large numbers may operate. Some cases have added the express requirements that the transferred risk must be an insurance risk and that in the absence of a statutory definition, "insurance" is to be defined in its commonly accepted sense.[3]

The Service initially issued Rev. Rul. 77-316, 1977-2 C. B. 53, which generally ruled that a parent company and its operating subsidiaries could not enter into an insurance arrangement with the parent's wholly-owned insurance subsidiary, to the extent that the

[1] "Risk shifting" is synonymous with "risk transfer."

[2] "Historically and commonly insurance involves risk-shifting and risk-distributing." Helvering v. Le Gierse, 312 U.S. 531, 539 (1941).

[3] Amerco v. Commissioner, 96 T.C. 18, 38 (1991), aff'd 979 F. 2d 162 (9th Cir. 1992); Harper Group v. Commissioner, 96 T.C. 45, 58 (1991), aff'd 979 F. 2d 1341 (9th Cir. 1992); Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61, 100-101, aff'd 972 F.2d 858 (7th Cir. 1992).

insurance company retained the risk of its affiliates. This was based on the view that the parent, each of the operating subsidiaries and the insurance company subsidiary were all members of the same "economic family," and that there could not be risk shifting within the "economic family." The IRS ruled that this was the case, even if the insurance company also insured risks of unrelated parties.[4] The IRS litigated many cases involving captive insurance. In many of the early cases, the IRS won because the court held that the parent and/or affiliates of the insurance company had not transferred their risk for a variety of reasons, generally relating to some deficiency in the financial arrangements. In later years, taxpayers won cases on one of two different fact patterns: (1) the operating subsidiaries (rather than the parent) were the insureds, or (2) the insurance company insured not only the parent's risks, but also sufficient (29%) unrelated risks.

In Rev. Rul. 2001-31, 2001-1 C.B. 1348, the Service announced that it was abandoning its "economic family" theory, but also stated (emphasis added): "The Service may, however, continue to challenge certain captive insurance transactions based on the facts and circumstances of each case." Accordingly, the Service initially (1977) attempted to impose an automatic prohibition on related party insurance. In 2001, the Service generally accepted captive insurance arrangements, unless they were shown to be improper based on the "facts and circumstances." Rev. Rul. 2002-89, 2002-2 C.B. 984, Rev. Rul. 2002-90, 2002-2 C.B. 985 and Rev. Rul. 2005-40, 2005-27 I.R.B. 4 subsequently provided the Service's view on some of the "facts and circumstances" associated with single parent captives. Since 1978, the Service has generally found group captive arrangements to be insurance for Federal income tax purposes. With all this as a background, the Service issued Notice 2005-49, asking for comments on, among other topics, the effect that loans of premiums to affiliates have on the qualification of a captive arrangement as insurance for Federal income tax purposes.

Prior Authority on Related Party Loans

There is scant authority on the effect of related party loans on a captive insurance arrangement. Rev. Ruls. 2002-89, 2002-90 and 2005-40 each state in their fact pattern that the insurance company does not loan any money to its affiliates; however, there is no discussion of the significance, if any, of this fact. Similarly, the remaining facts in each of the rulings are very "clean," except for the facts relating to the point that is ruled on (e.g., number of insureds, amount of outside business, whether disregarded operating LLCs count as insureds). By having a clean set of facts, the Rulings eliminated side issues; we do not interpret the fact that there were no loan backs in these rulings as establishing a bar to insurance if there are loan backs.

In Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985), the parent company owned two insurance companies that loaned money to, and invested in, the affiliates of the parent company. The court determined that there was no risk shifting. While it cited the loan backs as evidence of the lack of risk-shifting,[5] we believe a fair reading of the case is that the Court would not have found risk-shifting, even if there were no loan backs. This was

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[4] Rev. Rul. 88-72, 1988-2 C.B. 31 and Rev. Rul. 89-61, 1989-1 C.B. 75.

[5] Mobil, in reality, did not shift the risk of loss. Any losses suffered by the insurance affiliate would be reflected on Mobil's financial statements. Conversely, any profits realized by the affiliates benefited Mobil. This is illustrated by the fact that the profits from GOIC and Bluefield were invested in and were used to establish a credit line for other Mobil affiliates. See supra.

one of the earliest captive insurance cases and apparently viewed everything from the exclusive perspective of the parent. We believe that Rev. Rul. 2001-31 acknowledges that the jurisprudence has passed the Mobil case by. Specifically, Kidde v. United States, 40 Fed. Cl. 46 (1997) in the Court of Federal Claims (the successor court to the Claims Court), Humana v. Commissioner, 881 F.2d 247 (6th Cir. 1989), Hospital Corporation of America v. Commissioner, TC Memo 1997-482 and Rev. Rul. 2002-90 would all have reached a different conclusion on the "brother-sister" issue. Accordingly, we do not view Mobil as particularly helpful in addressing the significance of loan back of premiums.

The National Office reviewed a situation involving 97.5% loan backs in FSA 200202002 (9/28/01). This situation involved a number of other unfavorable factors including: the original policies were initially issued to two insureds for years 1 and 2, one of the insureds was the predominant insured (86 and 88% of the premiums in the original policies), the terms of a joint policy, the cancellation of year 2's policies and the reissuance retroactively of different coverages and additional insureds, a cavalier attitude towards formalities, late payment of premiums and questions whether the parties were dealing at arms-length. The FSA remarked, among other things, that by "loaning out substantially all of its assets to an affiliate, Insurance Subsidiary resembles an incorporated pocket-book, representing a reserve for self-insurance much like the one described in Spring Canyon, supra." Notwithstanding the very unfavorable facts and this statement, the National Office did not reject the situation out of hand, but recommended further factual development before the Agent concluded the deductions should be allowed. There was little analysis of the significance, if any, of the loan back, just a recognition that it was an issue. Accordingly, we do not view FSA 200202002 as particularly helpful in addressing the significance, if any, of a loan back of premiums, other than to caution that the captive should not be operated as "an incorporated pocketbook".

The National Office also issued FSA 199945009 (7/29/99) in which it agreed with the field's recommendation to concede a captive insurance case. The National Office also noted two factors that, if they had been more fully developed, might be available if the field had wanted to challenge the transactions. One such factor was the fact that "a significant portion of the premiums paid … to C were borrowed by H, thereby raising concerns about circular flows of cash." C was the captive insurance company and H was a foreign "brother-sister" finance company, though apparently not an insured. The terms of the loans were not provided to the National Office; the FSA did not quantify either the dollar amount or the percentage of the captive's assets that were loaned to the foreign affiliate. The National Office stated: "depending upon the facts of a particular case, the presence of circular flows of cash may indicate self-dealing, and could undermine a taxpayer's argument that the captive insurer was an independent entity that negotiated the terms of the 'insurance' transactions at arm's length. Since the facts concerning these loans between C and H are not clear, we cannot determine whether the resulting circular cash flows affect whether the transactions at issue are 'insurance'." We do not view these statements to be helpful in addressing the significance, if any, of a loan back of premiums, other than the general caution against a circular flow of funds.

Factors in Analyzing the Loan Back of Premiums

As noted in the summary, we believe that the proper approach to determining the significance, if any, of the loan back of premiums is to analyze it against the four factors identified in the summary. We believe that the first question is whether the arrangement

would be insurance, if there were no loan back; i.e., are the necessary elements or risk-shifting and risk distribution present. If they are present, then there is insurance unless something in the investment of the insurance company's assets so undermines the insurance company's ability to function as an insurer, that it invalidates these insurance elements. Because we believe that the insuring or underwriting function of the insurance company is an entirely different function than the investment function, we view it is highly unusual that the investments will invalidate the presence of insurance.

We believe that the four factors:

(a) Offer sufficient guidance to determine if one has a proper loan;

(b) Are flexible enough to address any fact situation; and,

(c) Are sufficiently strong to permit the Service to successfully challenge inappropriate fact situations.

Set forth below is an elaboration on the significance of each of the factors. In making our comments, we have assumed that the insureds have purchased what would be insurance if there were no loan backs and have assumed that the insureds have made bona fide premium payments.

1. Bona Fide Indebtedness:

An insurance company must invest its assets in order to obtain a reasonable return on its funds. Thus, for an insurance company to function as an insurance company, it must loan some or all of its funds to borrowers. The fact that the borrower is either an affiliate or an insured (either related or unrelated) does not diminish the validity of the loan or the rate of return.

In order for the loan to an affiliate or insured to be respected, it must be bona fide indebtedness. It must not be a sham and be enforceable. The note or other evidence of indebtedness, together with any security documents, should be commercially reasonable under the circumstances. If the debtor were delinquent, the insurance company could require payment and foreclose on any security (by demand or court enforced judgment), in accordance with the terms of the indebtedness. If a loan is not bona fide or not enforceable, it may indicate that it is not a loan, but a dividend or other gratuitous transfer. We also believe that there is ample case law to determine if a related party loan is a true debt, including whether the loan back is true debt even if it is close in time to the premium payment.

It is anticipated that the indebtedness will have commercially reasonable terms, including reasonable interest rates. If the terms are not commercially reasonable, the indebtedness would likely still be bona fide, but it may indicate that, for instance, the interest rate should be adjusted under Section 482 or 1271. If the terms are so divergent from commercially reasonable terms, the debt may not be a bona fide debt.

2. Permitted Loans:

The second factor to consider is whether the loan is permitted by the statute or the regulatory authorities of the insurance company's domicile. Such a permissible loan would evidence compliance with insurance law. Compliance with insurance law is evidence of an insurance company functioning as an insurance company, thus supporting the fact that the loan does not invalidate an otherwise-established insurance arrangement.

The fact that the loan is permitted by insurance regulation may not be as important a factor as the other three. Insurance regulation is not a prerequisite to insurance treatment; the relevant criteria are whether the arrangements themselves are insurance. Treas. Reg. §1.801-3(a)(1) makes this clear.[6] Moreover, Rev. Rul. 83-172, 1983-2 C.B.107 found a group workers' compensation arrangement to constitute insurance, even though it was not recognized as an insurance company under state insurance law (it was regulated by the Commerce Agency.)

If the relevant jurisdiction requires approval of the loan, obtaining such approval is a favorable factor; but no inference can be drawn from the absence of approval where approval was not required.

If the loan is not permitted but is nonetheless made, there is a question whether the insurance company is operating as an insurance company; however, making an impermissible loan (particularly if the violation was not willful) is not a per sé invalidation of an otherwise bona fide insurance relationship For instance, if the impermissible loan were made to an unrelated party in a highly regulated state and was an inadvertent violation, it should not automatically invalidate an insurance arrangement, even if the borrower was also an insured. An analysis of the facts and circumstance may conclude that an impermissible loan, with other factors, may invalidate an insurance arrangement, but such invalidation should not be automatic.

3. Liquidity of the Insurance Company:

An insurance company's primary function is to pay losses as and when they occur. Depending on the types of coverages, the losses may be paid for a short or long time after the policy period ends. It is imperative that an insurance company have liquid assets to make timely claim payments based on the types of coverages written and the projected timing of the losses. Loans with maturity dates that are consistent with meeting the insurance company's cash needs (after taking into account all the other available cash and resources of the insurance company) would support the operation of the insurance company and would support the insurance arrangement already established.

Even if there were no related party loans, the insurance company would need to project the timing of losses and resultant needs for cash. In determining the

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[6] Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

projected timing of losses, the insurance company may rely on commercially reasonable methods. The types of coverages, the historic loss payment patterns of the coverages, and the relative exposure in each coverage are all factors to be considered. If the types of coverages have not changed, historic loss patterns would normally be a valid method, particularly if there was no indication that the historic loss patterns were aberrant and there is no outlier loss in the captive's portfolio.. Reliance on actuarial data or contemporaneously written actuarial reports to determine the projected timing of losses would also be reasonable.

If the insurance company made loans with maturity dates that significantly exceeded the time when cash from repayments would be needed (after taking into account all the insurance company's other resources), the operation of the company as a true insurance company would need to be reviewed (this would be the case whether these loans were made to a related or unrelated debtor, and whether or not loaned to an insured.) Of course, payment patterns can shift unexpectedly, and under the facts and circumstances, unanticipated cash needs may be adequately supplied by borrowings (including borrowings secured by the notes representing the loans from the insureds).

4. Liquidity of the Borrower:

Even if the loan is bona fide, enforceable, permitted, has reasonable terms, and payment would provide the captive adequate liquidity, it may not produce cash flow if the borrower is illiquid and cannot pay. If it is commercially reasonable to assume that the borrower will repay its loan, as and when it comes due, then this is supportive of the already established insurance arrangement.

If repayment reasonably appears assured, no security is necessary, even if the loan is to an affiliate or to an insured (whether related or unrelated). For instance, clearly no security would be required if the captive invests in publicly traded, investment grade securities of the insured. Similarly, no security would be required if the borrower has established a sufficiently high published financial rating. Private companies or borrowers without high published financial ratings need not provide security, if it is commercially reasonable for the captive to make such loan without security on the terms proposed. If it would not be commercially reasonable to loan money without security, then security should be provided in a manner, and on terms, that are commercially reasonable.

If an outstanding loan becomes partially or wholly worthless, that does not automatically indicate that the insurance arrangement is invalid. It would more likely be corrected through the insurance regulatory process; for instance, if the loan's value reduces the insurance company's surplus, the insurance company may be required to raise capital. This obligation to raise capital would not necessarily call the insurance company's insurance arrangements into question.

What if the borrower is in questionable financial condition when the loan is being considered? We believe the issue remains the same: is it commercially reasonable to make the loan based on its terms? The interest rate from a troubled borrower would likely be higher, it may come with security and it may have a short enough term to make it a prudent loan. Can an insurance company invest in junk bonds?

Maybe so, if it is commercially reasonable and after review of any regulatory issues or constraints.

Specific Fact Patterns Addressed

Even if all the foregoing four criteria are unquestionably met, there may still be lingering questions, for instance:

a. If an insurance company loans money back to its insureds, have the insureds really transferred their risk?

b. Aren't the premiums from which the insurance company was to have paid losses, now held by the insureds themselves?

c. How will the insurance company meet its obligations if the borrowers go bankrupt?

d. Does it matter whether the loan back is close in time to the premium payment?

e. Does it matter if all the insurance company's assets are loaned to the insureds?

f. What if the loan is to an affiliate that is not an insured?

g. What if the loans are to the insureds in a different proportion than their premiums?

h. What if instead of a loan to the insured, the insured assigns its accounts receivables to the insurance company?

i. What if instead of a loan, the insurance company buys an interest in a trust to which the insured has transferred its accounts receivables?

We believe that these questions should be answered by measuring them against the four factors identified above. In doing so, it is imperative to recognize that the insurance function of an insurance company is divorced from the investment function.

a. Has the Risk Really Been Transferred when there is a Loan Back?

We have assumed that there is an insurance risk that was properly transferred and distributed. The insurance company now has cash that it must invest. If it invests it with an unrelated insured, how has it undermined or invalidated the insurance? For instance, if a public insurance company receives a $5,000,000 premium payment from Microsoft, will it not have insurance if it buys a $5,000,000 Microsoft bond? Even on the same day? We believe that the purchase of the Microsoft bond does not undermine the risk transfer under the policy. The obligations to pay losses have been transferred to the insurance company; those obligations have not been weakened or abrogated because of the purchase of the bond. The insurance company will pay the policy losses as and when they come due. We believe that if instead of a public insurance company, a captive insurance company is involved and, if instead of Microsoft, a privately held affiliate is involved,

the same insurance principles apply. If the insurance company continues to function as an insurance company and pays its losses as and when they come due, and, as contemplated by the four factors, the insureds and insurance company stay sufficiently liquid, then the loan from an insurance company to an affiliate or related or unrelated insured, does not automatically undermine the validity of the insurance arrangement.

b. Insured Holds Funds to Pay Losses

The second concern is whether the premiums from which the insurance company was to have paid claims are now held by the insured. The third factor of the four factors discussed above contemplates a repayment program to insure sufficient liquidity of the insurance company (after taking into account the other resources of the captive) to timely pay the losses. Thus, under the third factor, the investment would be repaid prior to its need to pay losses.

c. Bankruptcy of the Insured

Similarly, the possibility that an insured-borrower may go bankrupt is addressed by the fourth factor of the four factors described above. The insurance company must invest its funds; any entity it loans money to may go bankrupt. If the insurance company lends money to a company that goes bankrupt, then it may not be able to pay its losses; that is a result of bad investing, not entering into invalid insurance. If the loan were to an insured (whether or not related) and it appeared commercially reasonable at the time of the loan, then a subsequent bankruptcy may very likely be a bad investment, rather than a failure to form an insurance arrangement at the time of the loan.

d. Loan Back Closely Following the Payment Premium.

What if the loan back is close in time to the premium payment? This should only be a concern if it undermines the bona fide of debtor - creditor relationship. The insurance company is obligated to invest its excess cash. It will loan the money to someone. The fact that it is loaned to a related party or to an insured should not be relevant, if the indebtedness is bona fide and the four factors are met.

e. Lending all Excess Cash to the Insureds.

What if all or substantially all of the insurance company's excess cash is loaned back? If it is truly excess cash (cash in excess of current cash needs), then it must be loaned to someone. Clearly an insurance company can loan all its money to a single obligor if that obligor is the Federal government; for instance, an insurance company may buy only Treasury obligations with all its funds if it chose. The Federal government will never default, so there is no risk in lending all ones assets to the Federal government. Assume that Microsoft has the most free cash of any U.S. corporation; would it undermine an insurance arrangement for the insurance company to buy only Microsoft bonds where the likelihood of repayment is virtually 100%? If the goal of

lending money is a reasonable return based on the risk and timely payment of principal and interest, these goals would likely be met by lending to Microsoft. While such a concentration of lending to one entity may have some risks, it may still be commercially reasonable based on the terms of the loan. The insurance company's regulators may permit the loan to a single borrower. If it is commercially reasonable to assume the interest and principal of the loan will be timely repaid, the insurance arrangement should remain valid. The standard to apply is not whether the debtor is the strongest company in the nation, but merely whether it will repay the interest and loans in full when due.

f. Lending to a non-insured affiliate

The determination of whether risk shifting and risk distribution are present is independent of the insurance company's investments, except where the investments so compromise its ability to function as an insurance company. If an insurance company imprudently loans money to an unrelated entity, it does not undermine the insurance arrangements of the insurance company, unless it eliminates the insurance company's ability to function as an insurance company. We have discussed the four factors to take into account in determining if the loan back to an insured would ever invalidate an insurance arrangement with that insured; we think it is highly unlikely that the four factors would be violated in properly operating insurance companies. We think it would be almost nonexistent when the borrower is unrelated. Each affiliate must be viewed as a separate taxpayer under the principles of Moline Properties v. Commissioner, 319 U.S. 436 (1943) and National Carbide v. Commissioner, 336 U.S. 422 (1949). Moreover, pursuant to Rev. Rul. 2001-31, the Service has confirmed that it will not invoke the "economic family" theory with respect to captive insurance transactions, so it would seem ironic if the Service invoked the "economic family" theory with respect to loan backs. On that basis, unless there is some countervailing circumstance, non insured affiliates would generally be analyzed as if they were unrelated: it would be extremely rare that loans to them would so violate the four factors that they would undermine the insurance relationship with the insureds. We believe that this strong rule applies to members of the affiliated group. It is even more clear if the affiliate is not part of the affiliated group either because: it is a foreign affiliate; has common but individual owners; has common but less than 80% corporate owners; or, otherwise.

Is the answer different if the non insured affiliate then loans the money to an insured? While there could be tracing in an appropriate case, we reiterate that consistently applying the four factors will produce the proper answer.

g. Lending to insureds disproportionately to their premiums

What if the insurance company loans money to an affiliate-insured in a different ratio than the proportion of the insurance company's business

bought by the insured?[7] For instance, the insured pays 15% of the premiums, but is loaned 1% of the insurance company's assets? The concern that the loan back means the insured is paying its own losses is virtually nonexistent under these facts, but should be viewed by applying the four factors. What if an insured pays 5% of the premiums, but is loaned 10% of the insurance company's assets? The issue then reverts back to the application of the four factors discussed throughout this paper.

h. Buying the insureds' accounts receivables

An alternative to borrowing from the insured is to purchase the accounts receivables owed to the insured by the insured's customers on a non recourse basis, in exchange for a payment on commercially reasonable terms, including a commercially reasonable discount. We view this situation different than a loan back to the insured; and, assuming that the transaction proceeded on commercially reasonable terms, we believe that it would be extremely rare for this situation to invalidate an otherwise valid insurance arrangement between the insurance company and the insured. The apparent concern with a loan back to an insured is the question whether it somehow converts a bona fide insurance transaction into one where the insured is paying its own losses. In this case, the insurance company has invested in unrelated debt; it will receive its payment from completely unrelated persons or entities. So long as this investment did not undermine its integrity as an insurance company, there should be no issue. The fact that the insured owned these same receivables immediately before the insurance company has no relevance, so long as the transaction was commercially reasonable.

The fact that this creates no issues (in a commercially reasonable transaction) can be readily seen if this were viewed from two extremes. Suppose the insured paid for the insurance by transferring its accounts receivable. Assuming proper valuation and other commercially reasonable circumstances (e.g., the repayment of the receivables would satisfy the third factor) there could be no issue that this would undermine the insurance arrangements with the insured. Alternatively, if the insured had factored its receivables with an unrelated party and the insurance company purchased them from the unrelated factor, there would be no issue. In this context, it is clear that direct purchase of the receivables by the insurance company from the insured will not invalidate the insurance relationship.

Conclusion

Accordingly, meeting each of the four foregoing factors supports the proper operation of an insurance company and supports the already established insurance arrangement. If one or more factor is missing, in whole or in part, further review of the facts and circumstances would be required, but the insurance arrangement would not be automatically invalidated.

[7] For this purpose, we have assumed that the proportion of insurance an affiliate buys is in the same ratio as the premiums it pays.

III. *The relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance:*

Introduction

This portion of the submission addresses the request for comments on "the relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance."

Summary of Recommendations

It is our position that homogeneity and independence among risks may be relevant to achieving risk distribution, but neither is a necessary condition of risk distribution. This position is supported by prior rulings of the courts and the Service.

Discussion

It has long been recognized that risk shifting and risk distribution must be present for a transaction to qualify as insurance for federal tax purposes. *See Helvering v. Le Gierse, 312 U.S. 531 (1941).* In discussing the element of risk distribution, the courts and the Service have used a similar description:

> 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. 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 smoothes out losses to match more closely its receipt of premiums." *Clougherty Packing Company v. Commissioner, 84 T.C. 948 (1985), aff'd. 811 F.2d 1297 (9th Cir. 1987)*

The mathematical basis for risk distribution is often described as the "law of large numbers." Simply stated, the law of large numbers says that given a randomly selected group of independent, homogeneous exposures to a given event for which the probability of occurrence is known, then the larger the group of exposures the smaller will be the expected percentage deviation from the expected result.

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8 "Risk shifting" is synonymous with "risk transfer."

9 "Historically and commonly insurance involves risk-shifting and risk-distributing." Helvering v. Le Gierse, 312 U.S. 531, 539 (1941).

10 Amerco v. Commissioner, 96 T.C. 18, 38 (1991), aff'd 979 F.2d 162 (9th Cir. 1992); Harper Group v. Commissioner, 96 T.C. 45, 58 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992); Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61, 100-101, aff'd 972 F.2d 838 (7th Cir. 1992).

11 Mobil, in reality, did not shift the risk of loss. Any losses suffered by the insurance affiliate would be reflected on Mobil's financial statements. Conversely, any profits realized by the affiliates benefited Mobil. This is illustrated by the fact that the profits from GOIC and Bluefield were invested in and were used to establish a credit line for other Mobil affiliates. See, supra, pp. 7-8.

12 Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

13 For instance, the insured's relative proportion of premiums paid net of reinsurance.

In fact, in actual practice, an insurer cannot (and in many cases should not) exactly adhere to the theoretical construct of the law of large numbers. For example, risks assumed by an insurer are not randomly selected—they arise from the insured and the insurer actively seeking each other out. Therefore, instead of relying on randomness, insurers use *underwriting* processes (i.e., risk selection techniques) to try to eliminate their exposure to *anti-selection* (i.e., the transfer of a known riskier-than-average exposure to the insurer, such as an individual diagnosed with a terminal disease obtaining life insurance); careful risk selection, within the borders allowed by law, can create a pool of risks that, while clearly not random, will exhibit claims patterns like that of an otherwise similar randomly selected pool of risks.

Another deviation from the law of large numbers in insurance arises from the fact that the probability of claim associated with any given risk is almost never known. Instead of dealing with known probabilities, insurers must instead rely on statistical analysis of past claims experience to project an *estimate* of the probability of future claims experience.

Generally, insurance companies are viewed more favorably if they assume a variety of risks. For example:

- In rating insurance companies, A. M. Best generally gives a lower rating to an insurance company with a concentrated line of business, where the company underwrites only in a limited geographic area or business sector.

- The risk-based capital formulas promulgated by the National Association of Insurance Commissioners include credits for diversification in underwriting, which mean that an insurance company with diverse underwriting is required to maintain less capital with respect to a line of insurance business than it would if it wrote only that line of business. Thus, an insurer that writes a variety of insurance business lines, e.g., general liability, auto liability, workers compensation and property insurance (even for insureds within a specific industry sector) benefit from the reduced capital requirements. These formulas do not specifically reward an insurer that insures only homogeneous risks.

- Underwriting excessively homogeneous risks runs counter to general principles of risk distribution. Indeed, the Service has recognized this in denying deductions to participants in a reciprocal insurance exchange for amounts characterized as flood insurance premiums, where the insureds were in the same flood plain and all were likely to be affected by a single flood occurrence. *See* Rev. Rul. 60-275. The standard in the insurance industry is to underwrite a variety of lines of insurance for different industries as a means for adequately distributing risks.

It should be recognized that it is perfectly legitimate, and quite often desirable, for an insurer to manage several different types of risk (i.e., non-homogeneous risks) within its overall portfolio of assumed risks. In such case the risks are by definition not all homogeneous, and in all likelihood neither are they independent, with the result being that risk exposure may be less than what would be predicted by the law of large numbers. For example, a life and health insurer typically has several lines of business, often including life insurance, medical insurance, annuities, disability insurance and long term care insurance. In such multiple line insurance company, the insurer's combined risk exposure across all

lines is at most equal to the sum of the risk exposure in each line of business. However, if there is not complete independence of risks across the lines of coverage, the insurers total risk exposure will generally be less than the sum of the pieces. This result is due to the spread of risks across non-homogeneous lines of coverage.

The mathematical measure of independence between two events is often referred to as the "coefficient of correlation" and is assigned a value between -1 and 1. A coefficient of correlation equal to 1 denotes events which will always occur in combination with each other, a value of -1 denotes events that will never occur in combination, and a value of 0 denotes independence or a state in which the occurrence of one event has no bearing on whether or not the second event will occur.

Within a given line of insurance business, independence is usually desirable, because in the absence of independence there would likely be positive correlation of risks. Positive correlation arises from common exposure among risks (frequently called "contagion risk"), such as many insured buildings being in close geographic proximity, in which case if there was one claim for, say, loss due to hurricane damage, there would likely be multiple claims. Positive correlation creates fluctuation and unpredictability in an insurers claims experience, effectively reducing risk distribution. Negative correlation, on the other hand, would mean properties located in a geographically dispersed manner would distribute the risks and minimize claims.

On the other hand, for a multi-line insurer absolute independence across lines of insurance is entirely unnecessary. Regardless of whether there is independence or positive correlation of risks across lines of insurance, the insurer's total risk exposure is the sum of the exposures in each line of business. (In any event the insurer would probably have less risk exposure than a single line insurer with an equivalent amount of coverage written, because there is less of a likelihood of contagion risk across lines of coverage than within lines of coverage.) To the extent that there is negative correlation of risk across lines of insurance (i.e., a claim in one line reduces the likelihood of or even precludes a claim in another line) then the insurer's total risk exposure is less than the sum of the exposures in each line of business. In this case, risk distribution has been enhanced by the combination of non-homogeneous and non-independent risks.

In 1991 the Society of Actuaries published a paper written by Peter Deakins[14] that provides a simplified example of this complex issue. The paper focused specifically on the financial risk associated fluctuations in interest rates and the concept of combining lines of business to reduce this risk. "The idea is that if one line of business, for example, deferred annuities, benefits from falling interest rates and is hurt by rising interest rates, and a second line, for example, structured settlements, benefits from rising rates and is hurt by falling rates, then there should be some risk offsets when the two lines are combined. At worst, the risk arising from combining two lines cannot be worse than the sum of the two lines. At the other extreme, if the two lines are perfectly negatively correlated and the proportions of the two lines are right, then the result of combining the two lines will always be the sum of the mean results for the two lines, regardless of the [interest rate] scenario."

As a case study, Deakins considered an actual company that had written a mix of about 50 percent deferred annuities and 50 percent immediate annuities and structured

[14] Transaction of the Society of Actuaries 1991-92 Reports.

settlements. The study included the calculation of profits under 50 randomly generated interest scenarios on a line-by-line basis and on a combined basis. The results were as follows:

Summary of Results for 50 Random Trials
Present Value of Profits at Asset Earnings Rate
(Values Shown in Millions of Dollars)

	Mean	Low	10th Worst Result	Standard Deviation
Deferred Annuities	150.3	15.8	97.0	57.9
Structured Settlements	62.9	(24.4)	18.4	52.4
Combined	213.1	127.3	197.7	23.8

Deakins observes that "[t]he results are striking" and "show much less fluctuation between scenarios for the two lines combined than for either line separately on both a relative and an absolute basis. In addition ... the worst result for the combined lines is far better than the sum of the worst results for the two lines separately and in fact is significantly better than the worst results for either line by itself. ... [T]hese results indicate that there is substantially less risk for these two lines combined than there would be if the company had a comparable amount of business in either line by itself. In fact, given the assumptions used in this analysis, there is probably less risk for the two lines combined than for either line separately, even though the lines combined have twice as much reserves as either line has by itself."

Both the Service and the courts have consistently recognized that a valid insurance arrangement can include the insurance of non-homogeneous risk. In *AMERCO*, both the Tax Court and the Ninth Circuit Court of Appeals, though never specifically addressing homogeneity or independence of risks, implicitly recognized that combining multiple lines of non-homogeneous and not necessarily independent risks is not inconsistent with and does not diminish risk distribution. In this case the insurer, Republic, a subsidiary of AMERCO, issued coverages which included "(1) corporate policies issued to members of the AMERCO Group; (2) workers' compensation policies issued to members of the AMERCO Group; (3) U-Haul rental system policies, which covered members of the AMERCO Group, independent fleet owners, and truck rental customers; (4) SafeMove and SafeStor policies, which covered U-Haul rental customers; and (5) policies which covered risks entirely unconnected with the U-Haul system." The Court of Appeals noted "it was proper for the Tax Court to decide that there was sufficient risk distribution. The distribution aspect is rather apparent. As the Tax Court found, Republic's 'insurance business was diverse, [and] multifaceted....'" *AMERCO v. Commissioner, 96 T.C. 18 (1991), aff'd. 979 F.2d 162 (9th Cir. 1992).* Similarly, in *Harper v. Commissioner 979 F.2d 1341 (9th Cir. 1992),* one of the experts who testified, Dr. Neil A. Doherty, illustrated these phenomena with several calculations:

"Dr. Doherty prepared several calculations in an attempt to quantify the reduced risk resulting from the addition of premiums from unrelated insureds. He concluded that Rampart's risk would be 23.8 percent lower when it had 30 percent of premiums from unrelated insureds and 27.9 percent lower when the percentage of such premiums was 40 percent. In his view, these reductions in risk were significant."

Benefits Examples:

We believe the recent IRS guidance has encouraged addition of unrelated business to captives however fell short of recognizing the benefits of heterogeneous risk portfolios. On one hand, the recent IRS guidance on captive insurance steers captive owners towards creating diversified programs by adding unrelated business. On the other hand, the Service limits its safe-harbor parameters to cases with homogeneous risks. We believe the position of the Service limits captives' risk and insurance management capabilities.

The IRS Revenue Rulings 2005-40 and 2002-89 require that a captive underwrite 50% unrelated business in a given tax year for its parental business to be treated as insurance. As a result, many captive owners are considering or have considered adding unrelated business, such as warranty coverage or employee benefits programs, to their captives to meet this threshold. In such instances, addition of unrelated business such as employee benefits programs to an existing property/casualty captive would typically, if not always, make the captive's risk portfolio heterogeneous; e.g., insurance on the lives of a company's employees and company's buildings.

IRS Revenue Ruling 92-93 and General Counsel Memorandum 37791 clearly differentiate the employee benefits programs from corporate risk. Revenue Ruling 92-93 rules that premiums paid to a wholly-owned subsidiary entity for group-life insurance benefits of the parent's employees qualify as insurance for tax purposes. In the stating the legal rationale behind the ruling, the IRS states that:

> "Although X [the parent] purchased the group-term life insurance contract covering its employees from its wholly owned insurance subsidiary, S1, this fact does not cause the arrangement to be "self-insurance" because the economic risk of **loss being insured shifted to S1 is not a risk of [the parent] X** [emphasis added]."
>
> The Service further states that:
>
> "The amounts paid by X [parent] to [wholly-owned insurance subsidiary] S1 for group-term life insurance are part of the compensation for the employees' services. If an employer augments an employee's salary by paying the premiums on the employee's life insurance, the premiums are deductible business expenses provided the aggregate amount of compensation does not exceed reasonable compensation for the employee's services and provided the employer is not directly or indirectly a beneficiary under the policy…The Internal Revenue Service will not follow the decision in Gulf Oil to the extent that it denies a deduction for amounts a parent corporation pays to shift risks of unrelated employees and their beneficiaries to the parent's wholly owned insurance subsidiary."

General Counsel Memorandum 37791 a domestic corporation purchased an indemnity contract from a foreign insurer to reimburse the domestic company for all payments made by the domestic company to its employees under certain long-term disability plans. In ruling that the indemnity arrangement was "insurance" within the meaning of IRC Section 4371(2), the IRS stated:

> "Because the insurer is obligated to indemnify the domestic corporation for losses sustained by it under the disability plans, the risk assumed by the insurer under the insurance contract is **the same risk** [emphasis supplied] borne by the domestic corporation under the disability plans. The fact that the domestic corporation has passed its risk to the insurer does not change the nature of the risk. In this regard the instant arrangement is similar to one of reinsurance in which the primary insurer transfers some or all of the risk it has assumed to a second insurance company. [Citation omitted]. Thus the risk insured against under the instant contract is **the risk of injury to employees** [emphasis supplied] or former employees of the domestic corporation."

In Revenue Ruling 92-93 and General Counsel Memorandum 37791, risk of a group of employees has been shifted to a wholly-owned insurance subsidiary. Both the ruling and the memorandum clearly state that **when the indemnity arrangement is designed to cover a risk of loss to the employees, the arrangement should be viewed differently than when it covers a risk of loss that belongs exclusively to the company.** Moreover, as employees constitute a pool of independent risk units, risk distribution also exists in both instances. As a result, employee benefits programs described in these scenarios would be independent, homogeneous risks without the existence of any other line of coverage at the captive level.

As another example: "According to Couch, "the primary requisite to a contract of insurance is the assumption of a risk of loss, and the undertaking to indemnify the insured against such a loss " 1 G. Couch, Encyclopedia of the Law of Insurance § 1:3 (2d ed. 1965) (hereinafter cited as Couch on Insurance). The nature of the risk insured against determines the proper characterization of a given contract of insurance. See W. Vance, B. Anderson Handbook on the Law of Insurance 52 (3d ed. 1951); 43 Am. Jur. 2d. Insurance §§ 2, 4 (1969). We think an analysis of the contract described in the proposed ruling indicates that the risks against which it insures are related to "hazards to the person" within the meaning of section 4372(e).

In the conclusion in G.C.M. 35483, although the independent and separate nature of the disability plans mean that the employees, whose injuries or disabilities are the basis for the insurance risk calculation, are not parties to the actual insurance contract, we do not think that this lack of privity is determinative as to the nature of the contract.

As stated earlier, the nature of an insurance contract is determined by the character of the risk covered by the contract, and not by reference to which parties are in privity under the contract. This principle may be illustrated by reference to "key man" life insurance. Key man insurance is intended to "indemnify a business firm for the loss of earnings brought about by the death or disability of a key officer or other employee " S.S. Huebner, K. Black, Life Insurance 40 (8th ed. 1973). Typically, under a key man policy the employer pays the premiums and is the beneficiary under the contract; the key employee, whose life is the risk on which the contract is based, generally has no rights whatsoever under the policy. See W. Meyer, Life and Health Insurance Law § 25:4 (1972). Despite the absence of privity between the key employee and the parties to the contract on his life, however, it is clear that a key man life insurance policy would be considered a life insurance policy within the meaning of section 4371(2) and section 4372(e). Furthermore, it should be pointed out that under employer's liability or indemnity insurance contracts that cover injuries to employees (e.g. Workmen's Compensation Insurance), the employer and the insurer

generally are the only parties to the contract, and the employees have no rights thereunder. See 11 Couch on Insurance § 44:15.

On the other hand, when combined with the parent's homogeneous property/casualty risk, employee benefits programs would create a heterogeneous risk portfolio for the captive. The same would happen if the captive underwrites two different lines of employee benefits coverages such as Life Insurance and Long-Term Disability. In addition, such business, by the reasoning described above, i.e., creating a heterogeneous risk portfolio, would only improve a captive's overall risk profile. Lastly, addition of employee benefit lines would be consistent with Revenue Ruling 2005-40 in all aspects other than homogeneity.

We find the Service's unrelated business requirement while emphasizing homogeneity as a limiting factor on captive risk and insurance management. And we also believe that heterogeneous captive risk portfolios should not be excluded from meeting the IRS' requirement to qualify as insurance for tax purposes so long as they meet all the other facts and circumstances presented in Revenue Ruling 2005-40 and preceding rulings.

IV. Federal income tax issues raised by transactions involving finite risk.

While the Notice appears to be focused primarily on related party insurance arrangements (a.k.a., captive insurance) in general; the Notice seems to deviate when seeking commentary on transactions involving finite risk.

The term "finite risk" has received considerable media attention over the past several months and has been the subject of numerous inquiries by both federal and state regulatory bodies. These regulatory bodies have explored whether purported reinsurance transactions between unrelated parties were properly accounted for under US Generally Accepted Accounting Principles (e.g., US GAAP) as reinsurance as opposed to treated as deposit or banking transactions. The proper treatment of a contract may have significant accounting implications and many allege that improperly accounted for contracts have been used to misstate earnings of one or more parties to the contracts. However, finite risk transactions are generally not prevalent in the captive insurance context because they sought balance sheet strengthening which would typically eliminate in the consolidation of a captive insurance subsidiary and the insured affiliates and the desired financial statement benefits are not achieved.

FASB Statement 113 and Risk Transfer

In recent history, the US GAAP standard for determining whether a purported reinsurance arrangement should be accounted for as reinsurance or as some type of banking arrangement (e.g., deposit accounting) has been FASB Statement 113 (hereinafter the "Statement").[16] The Statement has been the subject of recent debate given the regulatory attention described above.

The Statement provides

[8]. Transaction of the Society of Actuaries 1991-92 Reports

[16] In December 1992, the FASB issued Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts. Statement 113 is effective for fiscal years beginning after December 15, 1992 and affects many existing reinsurance contracts, as well as all contracts entered into after the Statement's effective date.

> This Statement establishes the conditions required for a contract with a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. The accounting standards depend on whether the contract is long duration or short duration and, if short duration, on whether the contract is prospective or retroactive. For all reinsurance transactions, immediate recognition of gains is precluded unless the ceding enterprise's liability to its policyholder is extinguished. Contracts that do not result in the reasonable possibility that the reinsurer may realize a significant loss from the insurance risk assumed generally do not meet the conditions for reinsurance accounting and are to be accounted for as deposits.

Under the Statement, in order for a reinsurance arrangement to transfer risk from the ceding insurer to the reinsurer, the arrangement must provide a "reasonable possibility that the reinsurer may realize a significant loss". The meaning of this phrase has been (and continues to be) subject to interpretation (and debate) by accounting professionals, regulators and actuaries. In analyzing reinsurance contracts the Statement requires

> Determining whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding enterprise and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

The analysis takes the form of evaluation of the projected cash flows

> 10. The ceding enterprise's evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming enterprises under reasonably possible outcomes, without regard to how the individual cash flows are characterized. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested.
>
> 11. Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 10, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding enterprise shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer.

The cash flow analysis generally applied under the Statement is supported by actuarial estimates.

It should be noted that both the Financial Accounting Standards Board and the National Association of Insurance Commissioners has stated that they would be re-addressing the concept of risk transfer from both a financial reporting context and a statutory reporting context. As such, consideration should be given to any pending changes which may be forthcoming from the FASB or NAIC.

Insurance Defined for US Federal Income Tax Purposes

We believe that the presence or absence of "risk transfer" as set forth under FASB Statement 113 from a US GAAP perspective has no direct bearing on the federal taxation of a purported reinsurance contract. The term "risk transfer" is not a requisite component of an insurance transaction for federal income tax purposes.

Neither the Code nor the Regulations[17] thereunder define the terms "insurance" or "insurance contract". As such, whether a transaction qualifies as insurance has been judicially defined. The courts have typically begun their analysis with the consideration of a US Supreme Court case, which dealt with a life insurance transaction. According to the US Supreme Court in *Helvering v. Le Gierse*[18], a valid insurance contract requires the presence of insurance risk and involves both risk shifting and risk distribution. In 1991, the United States Tax Court decided three cases which expanded this definition of insurance.[19] In its decisions in those cases, the Tax Court proposed a three-part test for determining whether an insurance contract exists. These tests ask:

- Whether the arrangement involves an insurance risk;
- Whether the arrangement provides both risk-shifting and risk distribution; and
- Whether the arrangement is insurance in its commonly accepted sense.

Case law has defined an insurance contract as "a contract whereby, for an adequate consideration, one party undertakes to indemnify another against loss arising from certain specified contingencies or perils. . . . [I]t is contractual security against possible anticipated loss".[20] The risk transferred under the contract must involve the assumption of another's risk of economic loss.[21]

No separate definition exists for "reinsurance" versus "insurance". Reinsurance is essentially "insurance" for an "insurance" company.

Insurance Risk or Risk Transfer

The interchanging of the terms "risk shifting" and "risk transfer" tends to occur quite frequently by many tax practitioners which has led to what we believe to be an often

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[17] The Internal Revenue Code of 1986 (the "Code" or "IRC") and the Treasury Regulations promulgated pursuant to the Code (the "Regulations" or "Reg.")
[18] *Helvering v. Le Gierse,* 39 B.T.A. 1139 (1939), aff'd 110 F.2d 734 (1940), rev'd 312 US 521 (1941).
[19] *AMERCO and Subsidiaries v. Commissioner,* 96 T.C. 45 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992); *Sear, Roebuck and Co. and Affiliated Corporations vs. Commissioner*, 96 T.C. 61 (1991), Modified and supplemented by 96 T.C. 671 (1991), aff'd in part and rev'd in part 972 F.2d 858 (7th Cir. 1992); and *Harper Group and Includable Subsidiaries v. Commissioner*, 96 T.C. 45 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992).
[20] *Epmeier v. United States*, 199 F.2d 508 (7th Cir. 1952).
[21] *Allied Fidelity Corp. v. Commissioner*, 66 T.C. 1068 (1976), aff'd, 572 F.2d 1190 (7th Cir. 1978); Rev. Rul. 89-96, 1989-2 C.B. 114.

incorrect presumption that if an arrangement meets the "risk transfer" standard under FASB Statement 113, that the arrangement provides for "risk shifting" from a federal tax perspective. We think that the concept of "risk transfer" as set forth under FASB Statement 113 is more correctly aligned with the tax concept of "insurance risk" versus "risk shifting".

The courts and the Service have provided very little substantive guidance in determining what constitutes adequate insurance risk from a US federal tax perspective. The following discussion on the issue of insurance risk was included in an IRS litigation memorandum:

> Businesses face hazards that expose them to adverse but uncertain financial consequences. These hazards are referred to as pure risks or insurable risks (in contrast to investment or speculative risks). A "pure risk" is defined by one of the government's trial experts, Dr. Irving H. Plotkin, as a risk that can only have bad or neutral results.[22] An example of a pure risk is a fire or accident. A speculative or investment risk can have good, bad, or neutral results. An example of a speculative risk is the risk of whether a profit or loss will be generated from the conduct of a business or by taking a position on foreign currency. The insurance industry generally does not offer products to manage these types of risks. R. Riegel, J. Miller, & C. Williams, Insurance Principles and Practices: Property and Liability 2 (6th ed. 1976). Only a pure risk is an insurable risk (also known as an insurable interest). When this type of risk is transferred to an insurance company, the insured has relieved itself of the financial uncertainty concerning the consequences of an event. In the hands of the insurer, however, the pure risk of the insured has become an investment risk; will the loss cost more or less than the accumulated premiums and investment earnings?[23]

The Supreme Court in *Le Gierse* cited insurance risk as a requisite component of insurance and distinguished between an insurance risk and an investment risk.[24] In the case, an elderly woman purchased a single premium life insurance policy in the amount of $25,000 for approximately $23,000. In connection with the insurance, the insurer required the insured woman to buy an annuity for approximately $4,100. In total, the elderly woman paid more than $27,000 for a $25,000 benefit, and died soon thereafter. The Court concluded that the annuity contract and life insurance contract should be considered together in deciding whether an insurance risk actually existed. Reasoning that an annuity contract and a life insurance contract covering the same life are opposites and that one neutralized the risk customarily inherent in the other, the Court held that when viewed together the contracts exhibited no insurance risk.

In *AMERCO*,[25] the Tax Court first specified insurance risk as a necessary component of an insurance relationship, but did not identify the characteristics of insurance risk. The court provided in its decision that "[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 risks exist, then insurance cannot be present. "insurance risk" is required, investment risk is insufficient."

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[22] See the *Harper Group v. Commissioner*, T.C. Docket No. 33761-85, Report of Irving H. Plotkin, p. 7l
[23] LGM TL-85 (January 24, 1999).
[24] *Helvering v. Le Gierse*, 312 U.S. 531 (1941).
[25] *AMERCO v. Commissioner*, 96 T.C. 18, 31 (1991).

To date the only ruling issued by the Internal Revenue Service addressing the presence of absence of “insurance risk” was Revenue Ruling 89-96[26] which considered whether a retroactive insurance arrangement would be considered an insurance contract for US federal tax purposes.[27] In the Ruling the IRS examined a catastrophic insurance policy which covered losses from a fire that had already occurred. The losses from the catastrophe were already known and estimated with reasonable accuracy. The insured entered into an agreement with an insurer whereby the insurer would cover certain losses incurred in the fire in exchange for a premium. The amount of the premium approximated the net present value of the expected payout of the anticipated losses covered under the insurance contract. It was expected that the insurer would invest the premium and net tax savings (from deducting the reserves in excess of the premium received) and earn thereon some rate of return until such time as the insurer would be required to pay the known claim. The insurer would use the premium and any accumulated investment return to pay covered losses.

The Service held in this ruling that the contract did not qualify as an insurance contract because it did not involve the insurance company’s assumption of an insurance risk. The losses with regard to the catastrophe were no longer contingent. There was no uncertainty as to the existence of the loss, since it was known, or the amount of the loss, as the losses were already determined with reasonable accuracy to exceed the stated limits under the policy. The only uncertainty faced by the insurer was whether they would be able to invest the premium and tax savings long enough to earn sufficient investment income to cover the gap between the premiums received and the policy limit. The premium was simply based on the net present value of these anticipated losses. Since there was no uncertainty as to the occurrence or amount of the losses, there was no insurance risk that was transferred from the taxpayer to the insurer.

On the other hand, the contract did transfer the risk that the premium received and earnings on investment of the premium would not be adequate to cover the anticipated losses. However, the Service characterized this as an investment risk. Because an insurance company’s assumption of an investment risk alone cannot create an insurance arrangement, the Service characterized the arrangement as a financing transaction.[28]

Typically, an arrangement under which the risk to the counter-party is fixed and the counter-party faces only timing or investment risk and does not face insurance risk is not an insurance contract for US federal tax purposes. Further, an arrangement which possess these same characteristics would most likely not be accounted for as reinsurance under FASB Statement 113 which we believe to be proper. The IRS, in a technical advice memorandum addressed these facts.

In TAM 9029002 the Internal Revenue Service addressed the treatment of certain “reinsurance contracts” entered into by the Taxpayer. In the facts as presented, the Taxpayer entered into certain reinsurance contracts which were reported as reinsurance arrangements on the Taxpayer’s NAIC Annual Statement but were treated as financing arrangements on the Taxpayer’s federal income tax return. The State Insurance

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[26] Rev. Rul. 89-96, 1989-2 C.B. 114.

[27] Discussed in Gen. Couns. Mem. 39, 795 (April 15, 1989) & Gen. Couns. Mem. 39, 796 (June 6, 1989).

[28] *Securities and Exchange Commission v. United Benefit Life Ins. Co.,* 387 U.S. 202, 210 (1976), citing *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

Commissioner upon audit determined that the contracts did not transfer insurance risk. In determining the whether the contracts should be considered reinsurance, the IRS applied *Le Gierse* to the transaction and determined that no "risk transfer" existed under contracts and they should not be treated as reinsurance contracts.

Based on recent IRS exam experience, we understand that if it has been determined that a transaction has adequate risk transfer under FASB Statement 113, the Service will generally accept that there exists sufficient insurance risk under the arrangement to meet the US federal income tax criteria. However, if an arrangement fails to meet the risk transfer standard under FASB Statement 113, we do not consider that conclusive that insurance risk is absent under the contractual terms and that the contract does not contain sufficient risk for US federal tax purposes.

As discussed above, the application of FASB Statement 113 to a particular arrangement is based upon using a projected cash flow analysis which is based upon an actuarial estimation. A reinsurance contract may fail to transfer risk under a US GAAP concept and still contain contractual insurance risk based upon a possibility of loss versus a probability of loss. The Tax Court has respected the contractual "probability of loss" in finding for the Taxpayer in *Trans City Life Insurance Company v. Commissioner*.[29]

We believe the proper application of the "risk transfer" concept contained under FASB Statement 113 in a US federal income tax context should be limited to evidence of the presence of insurance risk within an arrangement and should not be used to conclude insurance risk is not present if an arrangement fails to transfer risk under FASB Statement 113. Our thoughts are based upon the current practical application of FASB Statement 113 and we believe the Service should consider any pending changes to FASB Statement 113 which may be promulgated by either the NAIC, FASB or AICPA in the future.

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[29] See *Trans City Life Insurance Company v. Commissioner,* 106 T.C. 274.

[30] In December 1992, the FASB issued Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts. Statement 113 is effective for fiscal years beginning after December 15, 1992 and affects many existing reinsurance contracts, as well as all contracts entered into after the Statement's effective date.

[31] The Internal Revenue Code of 1986 (the "Code" or "IRC") and the Treasury Regulations promulgated pursuant to the Code (the "Regulations" or "Reg.")

[32] *Helvering v. Le Gierse*, 39 B.T.A. 1139 (1939), aff'd 110 F.2d 734 (1940), rev'd 312 US 521 (1941).

[33] *AMERCO and Subsidiaries v. Commissioner*, 96 T.C. 18 (1991), aff'd 979 F.2d 162 (9th Cir. 1992); *Sears, Roebuck and Co. and Affiliated Corporations vs. Commissioner*, 96 T.C. 61 (1991), Modified and supplemented by 96 T.C. 671 (1991), aff'd in part and rev'd in part 972 F.2d 858 (7th Cir. 1992); and *Harper Group and Includable Subsidiaries v. Commissioner*, 96 T.C. 45 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992).

[34] *Epmeier v. United States*, 199 F.2d 508 (7th Cir. 1952).

[35] *Allied Fidelity Corp. v. Commissioner*, 66 T.C. 1068 (1976), aff'd, 572 F.2d 1190 (7th Cir. 1978), Rev. Rul. 89-96, 1989-2 C.B. 114.

[36] See *Humana, Inc. v. Commissioner*, T.C. Memo 1985-426 (1985), reconsideration 88 T.C. 197 (1987), aff'd in part and rev'd in part 881 F.2d 247 (6th Cir. 1989); *Malone & Hyde, Inc. v. Commissioner*, T.C. Memo. 1989-604 (1989), suppl'd T.C. memo. 1993-585 (1993), rev'd 62 F.3d 835 (6th Cir. 1995); *Hospital Corp. of America v. Commissioner*, TC Memo 1997-482 (1997); and *Kidde Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997).

[37] See *AMERCO and Subsidiaries v. Commissioner*, 96 T.C. 18 (1991), aff'd 979 F.2d 162 (9th Cir. 1992); *Sears, Roebuck and Co. and Affiliated Corporations vs. Commissioner*, 96 T.C. 61 (1991), Modified and supplemented by 96 T.C. 671 (1991), aff'd in part and rev'd in part 972 F.2d 858 (7th Cir. 1992); and *Harper Group and Includable Subsidiaries v. Commissioner*, 96 T.C. 45 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992); and *Ocean Drilling & Exploration Co.,* 988 F.2d 1135.

[38] See the *Harper Group v. Commissioner*, T.C. Docket No. 33761-85, Report of Irving H. Plotkin, p.7.

[39] LGM TL-85 (January 24, 1990)

[40] *Helvering v. Le Gierse* 312 U.S. 531 (1941).

[41] *AMERCO v. Commissioner*, 96 T.C. 18, 38 (1991).

[42] See *Trans City Life Insurance Company v. Commissioner*, 106 T.C. 274.

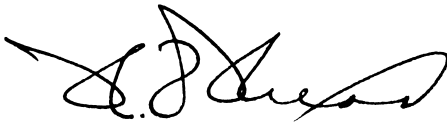
Conclusion

The Captive Insurance Companies Association respectfully submits the foregoing comments for the Service and Treasury Department's consideration. Again we thank the Service and Treasury Department for requesting comments and allowing us the opportunity to respond on behalf of the captive insurance industry. If the Service and Treasury Department have any additional questions, we would be happy to respond.

Respectfully Submitted,

Terry E. Young, Chair of the Board of Directors

Dennis P. Harwick, President



Michael R. Mead, Chair – CICA Task Force