Part I

Section 162.--Trade or Business Expenses

26 CFR 1.162-1: Business Expenses.
(Also §§ 801, 831)

Rev. Rul. 2008-8

ISSUES

Under the facts described below, do the arrangements entered into between X and Cell X, and between the subsidiaries of Y and Cell Y, of Protected Cell Company constitute insurance for federal income tax purposes? If so, are amounts paid by X to Cell X and by the subsidiaries of Y to Cell Y deductible as "insurance premiums" under § 162 of the Internal Revenue Code?

FACTS

Protected Cell Company is a legal entity formed by Sponsor under the laws of Jurisdiction A. Pursuant to the laws of Jurisdiction A, Protected Cell Company has established multiple accounts, or cells, each of which has its own name and is identified with a specific participant, but is not treated as a legal entity distinct from Protected Cell Company. Sponsor owns all the common stock of Protected Cell Company. All of the non-voting preferred stock associated with each cell is owned by that cell's participant or participants. The

terms “common stock” and “preferred stock” as used in the Protected Cell Company and cell instruments do not necessarily reflect the federal income tax status of those instruments.

Each cell is funded by its participant’s capital contribution (the amount paid by the participant for the preferred stock associated with its cell) and by "premiums" collected with respect to contracts to which the cell is a party. Each cell is required to pay out claims with respect to contracts to which it is a party. The income, expense, assets, liabilities, and capital of each cell are accounted for separately from the income, expense, assets, liabilities, and capital of any other cell and of Protected Cell Company generally. The assets of each cell are statutorily protected from the creditors of any other cell and from the creditors of Protected Cell Company. Protected Cell Company maintains non-cellular assets and capital representing the minimum amount of capital necessary to maintain its charter. Each cell may make distributions with respect to the class of stock that corresponds to that cell, regardless of whether distributions are made with respect to any other class of stock. In the event a participant ceases its participation in Protected Cell Company, the participant is entitled to a return of the assets of the cell in which it participated, subject to any outstanding obligations of that cell.

A company like Protected Cell Company is sometimes referred to as a protected cell company, a segregated account company or segregated portfolio company.

Situation 1.

X, a domestic corporation, owns all the preferred stock issued with respect to Cell X. Each year, X enters into a 1-year contract, or arrangement, whereby Cell X "insures" the professional liability risks of X, either directly or as a reinsurer of those risks. The amounts X pays as "premiums" under the annual arrangement are established according to customary industry rating formulas. In all respects, X and Cell X conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties. In implementing the arrangement, Cell X may perform any necessary administrative tasks, or it may outsource those tasks at prevailing commercial market rates. X does not provide any guarantee of Cell X's performance, and all funds and business records of X and Cell X are separately maintained. Cell X does not loan any funds to X. Cell X does not enter into any arrangements with entities other than X. Taking into account the total assets of Cell X, both from capital contributions and from amounts received pursuant to the annual arrangement with X, Cell X is adequately capitalized relative to the risks assumed under that arrangement.

Situation 2

The facts are the same as in Situation 1, except that Y, a domestic corporation, owns all the preferred stock issued with respect to Cell Y. Y also owns all of the stock of 12 domestic subsidiaries that provide professional services. Each subsidiary in the Y group has a geographic territory comprised of a state in which the subsidiary provides professional services. The subsidiaries of Y operate on a decentralized basis. The services provided by the employees

of each subsidiary are performed under the general guidance of a supervisory professional for a particular facility of the subsidiary. The general categories of the professional services rendered by each of the subsidiaries are the same throughout the Y group. Together the 12 subsidiaries have a significant volume of independent, homogeneous risks.

Each year, each subsidiary of Y enters into a 1-year contract, or arrangement, with Cell Y whereby Cell Y "insures" the professional liability risks of that subsidiary, either directly or as a reinsurer of those risks. The amounts charged each subsidiary as "premiums" under the annual arrangements are established according to customary industry rating formulas. None of the subsidiaries have liability coverage for less than 5% nor more than 15% of the total risk insured by Cell Y. Cell Y retains the risk that it insures from the subsidiaries. In all respects, Y, Cell Y, and each subsidiary, conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties. In implementing the arrangement, Cell Y may perform all necessary administrative tasks, or it may outsource those tasks at prevailing commercial market rates. Neither Y nor any subsidiary of Y guarantees Cell Y's performance, and all funds and business records of Y, Cell Y, and each subsidiary, are separately maintained. Cell Y does not loan any funds to Y or to any subsidiary of Y. Cell Y does not enter into any arrangements with entities other than Y or its subsidiaries. Taking into account the total assets of Cell Y, both from capital contributions from Y and from amounts received pursuant to the annual arrangements with the subsidiaries of Y, Cell Y is adequately capitalized

relative to the risks assumed under those arrangements.

LAW

Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1(a) of the Income Tax Regulations provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident or other similar losses in the case of a business.

Neither the Code nor the regulations define the terms insurance or insurance contract. The United States Supreme Court, however, has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941).

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution occurs when the party assuming the risk distributes its potential liability among others, at least in part. Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986). Risk distribution "emphasizes the broader, social aspect of insurance as a method or dispelling the danger of a potential loss by spreading its cost throughout a group", Commissioner v. Treganowan, 183 F.2d 288, 291 (2d Cir. 1950), and "involves spreading the risk of loss among policyholders." Ocean Drilling &

Exploration Co. v. United States, 24 Cl. Ct. 714, 731 (1991) aff'd per curiam, 988 F.2d 1135 (Fed. Cir. 1993). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

A transaction between a parent and its wholly-owned subsidiary does not satisfy the requirements of risk shifting and risk distribution if only the risks of the parent are insured. See Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985); Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981), cert. denied 454 U.S. 965 (1981). However, courts have held that an arrangement between a parent and its subsidiary can constitute insurance when the parent's premiums are pooled with those of unrelated parties if (i) insurance risk is present, (ii) risk is shifted and distributed, and (iii) the transaction is of the type that is insurance in the commonly accepted sense. See, e.g., Ocean Drilling & Exploration Co.; AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992); Rev. Rul. 2002-89, 2002-2 C.B. 984. An arrangement between an insurance subsidiary and other subsidiaries of the same parent may qualify as insurance for federal income tax purposes, even if there are no insured policyholders outside the affiliated group, provided the requisite risk shifting and risk distribution are present. See, e.g., Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989); Kidde Industries v. U.S., 40 Fed. Cl. (1997); Rev. Rul. 2002-90, 2002-2 C.B. 985.

The qualification of an arrangement as an insurance contract does not depend on the regulatory status of the issuer. See, e.g., Commissioner v. Treganowan, 183 F.2d 288 (2d Cir. 1950) (arrangement with stock exchange

"gratuity fund" treated as life insurance because the requisite risk shifting and risk distribution were present). See also Rev. Rul. 83-172, 1983-2 C.B. 107 (group issuing workmen's compensation insurance taxable as an insurance company even though not recognized as an insurance company under state law); Rev. Rul. 83-132, 1983-2 C.B. 270 (non-corporate business entity taxable as an insurance company if it is primarily engaged in the business of issuing insurance contracts). The same principles apply to determine the insurance contract status of an arrangement involving a cell of a protected cell company as apply to determine the status of an arrangement with any other issuer.

ANALYSIS

In order to determine the nature of an arrangement for federal income tax purposes, it is necessary to consider all the facts and circumstances in a particular case, including not only the terms of the arrangement, but also the entire course of conduct of the parties. Thus, an arrangement that purports to be an insurance contract but lacks the requisite risk distribution may instead be characterized as a deposit arrangement, a loan, a contribution to capital (to the extent of net value, if any) an indemnity arrangement that is not an insurance contract, or otherwise, based on the substance of the arrangement between the parties. The proper characterization of the arrangement may determine whether the issuer qualifies as an insurance company and whether amounts paid under the arrangement may be deductible.

Under the facts presented, all the income, expense, assets, liabilities and capital of Cell X are separately accounted for and, upon liquidation, become the

property of X, who is the sole shareholder with respect to Cell X. The amounts X pays as premiums under the 1-year agreement to "insure" its professional liability risks are held by Cell X, together with any capital and surplus, for the satisfaction of X's claims. The premiums that Cell X earns from its arrangement with X constitute 100% of its total premiums earned during the taxable year; the liability coverage Cell X provides to X accounts for all the risks borne by Cell X. In the event of a claim, payment will be made to X out of X's own premiums and contributions to the capital of Cell X; no amount may be paid out of any other cell in satisfaction of any claims by X. The arrangement between X and Cell X is akin to an arrangement between a parent and its wholly-owned subsidiary, which, in the absence of unrelated risk, lacks the requisite risk shifting and risk distribution to constitute insurance. Because Cell X does not enter into arrangements with any policyholders other than X, the arrangement between X and Cell X is not an insurance contract for federal income tax purposes, and X may not deduct amounts paid pursuant to the arrangement as "insurance premiums" under § 162. See Rev. Rul. 2005-40, 2005-2 C.B. 4 (arrangement lacks necessary risk distribution, and therefore does not qualify as insurance, if the issuer of the arrangement contracts with only a single policyholder); Rev. Rul. 2002-89, 2002-2 C.B. 984 (amounts paid by a domestic parent corporation to its wholly owned insurance subsidiary are not deductible as insurance premiums if the parent's premiums are not sufficiently pooled with those of unrelated parties).

All the income, expense, assets, liabilities and capital of Cell Y likewise are separately accounted for, and upon liquidation, become the property of Y,

who is the sole shareholder with respect to Cell Y. Under the arrangements between the 12 subsidiaries of Y and Cell Y, the subsidiaries shift to Cell Y their professional liability risks in exchange for premiums that are determined at arms-length. Those premiums are pooled such that a loss by one subsidiary is not in substantial part, paid from its own premiums. The subsidiaries of Y and Cell Y conduct themselves in all respects as would unrelated parties to a traditional insurance relationship. Had the subsidiaries of Y entered into identical arrangements with a sibling corporation that was regulated as an insurance company, the arrangements would constitute insurance and amounts paid pursuant to the arrangements would be deductible as insurance premiums under § 162. See Rev. Rul. 2002-90, 2002-2 C.B. 985. The fact that the subsidiaries' risks were instead shifted to a cell of a protected cell company, and distributed within that cell, does not change this result. Accordingly, the arrangements between Cell Y and each subsidiary of Y are insurance contracts for federal income tax purposes; amounts paid pursuant to those arrangements are insurance premiums, deductible under § 162 if the requirements for deduction are otherwise satisfied.

HOLDINGS

In Situation 1, the annual arrangement between Cell X and X does not constitute insurance for federal income tax purposes. In Situation 2, the arrangements between Cell Y and each subsidiary of Y do constitute insurance for federal income tax purposes; amounts paid pursuant to those arrangements are deductible as insurance premiums under § 162 if the requirements for

deduction are otherwise satisfied.

ADDITIONAL GUIDANCE

The Internal Revenue Service and the Treasury Department are aware that further guidance may be needed in this area. Notice 2008-19, this Bulletin, requests comments on further guidance that addresses when a cell of a Protected Cell Company is treated as an insurance company for federal income tax purposes.

DRAFTING INFORMATION

The principal author of this revenue ruling is Chris Lieu of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling contact Mr. Lieu at (202) 622-3970 (not a toll-free call).