Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel
(Large & Mid-Size Business)

from: Sheryl B. Flum
Branch Chief, Branch 4
(Financial Institutions & Products)

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

X =
Y =

Parent =
Sub 1 =
Cell 1 =
Year 1 =
Year 2 =
FC 1 =
FC 2 =
Date 1 =
Lines =

Number 1 =
Number 2 =
Number 3 =
Number 4 =
Number 5 =

Number 6 =
Number 7 =
Number 8 =
Number 9 =
Number 10 =
Number 11 =
Number 12 =
Number 13 =
Line 1 =

ISSUES

I. Is the revenue agent's approach to aggregating the premiums of an "insured group" [1] correct?

II. How do we apply facts relating to homogeneity of risks in analyzing whether there is sufficient risk shifting and risk distribution to merit insurance treatment?

III. Do the facts indicate that risk was adequately shifted and distributed if each Insured[2] is a brother/sister corporation of Cell 1?

IV. Do the facts indicate that risk was adequately shifted and distributed if each Insured is not a brother/sister corporation of Cell 1?

V. Do the facts indicate that the risk was adequately shifted and distributed if each Insured is treated as an owner of Cell 1 solely for the purpose of determining whether an insured/policyholder has an equity interest in Cell 1?

CONCLUSIONS

I. The revenue agent's approach to aggregating the premiums of an "insured group" is incorrect.

II. We are not able to provide you with advice on the application of homogeneity to the insurance analysis.

III. The facts indicate that risk may have been adequately shifted and distributed if each Insured of Parent is a brother/sister corporation of Cell 1.

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[1] For purposes of this memorandum, an "Insured Group" may consist of a single corporation, which Parent wholly owns and which receives insurance coverage from Cell 1. In addition, an "insured group" may consist of a corporation (which Parent wholly owned), a subsidiary of that corporation and a division/disregarded entity of that subsidiary, which received insurance coverage from Cell 1. The term "insured group" is not defined in any document that the taxpayer has produced, and the taxpayer does not use that term when describing the entities that received insurance coverage from Cell 1.
[2] Defined below.

IV. The facts indicate that risk may have been adequately shifted and distributed if each Insured is not a brother/sister corporation of Cell 1.

V. The facts indicate that the risk may have been adequately shifted and distributed if each Insured is treated as an owner of Cell 1 solely for the purpose of determining whether an insured/policyholder has an equity interest in Cell 1.

FACTS

The Year 1 and Year 2 tax years of Y are under examination. Y is a calendar year taxpayer.

X was incorporated in FC 1. X is a mutual insurance company that provides insurance coverage to (and is owned and controlled by) its members, who are policyholders (each a "Member"). A Member has voting rights in X (as a result of a policyholder's ownership interest in X). X elected to be treated as a United States domiciled taxpayer pursuant to I.R.C. § 953(d) for the years under examination.

X owned a 100 percent interest in Y during the years under examination (i.e., Year 1 and Year 2). Y was incorporated under the laws of FC 2 on Date 1. Y elected to be treated as a United States domiciled taxpayer pursuant to I.R.C. § 953(d). That election was in effect during the years under examination.

Y was a segregated cell company during the years under examination. Y formed segregated cells for each Member with which it conducted business; each cell was set up as a captive. Each cell has its own name and is identified with a specific Member with which Y conducted business; however, a cell is not treated as a distinct legal entity under the laws of FC 2, however for the purposes of this advice we will assume that it is nonetheless a separate taxable entity.

If either X or Y is liquidated, a Member receives the assets upon liquidation.

Typically, an "insured" party related to the Member would enter into a contract with Y for their respective cell to "insure" or "reinsure" certain risks. Y would receive the premiums from the "insured" party and would distribute those premiums to the account of the "insuring" cell.

The "insured" party did not receive a direct ownership interest in their respective cell under the terms of the contract. In addition, the "insured" party did not have any ownership rights in Y. Instead, the "insured" party could appoint advisors to Y's advisory committee (i.e., the advisory board). Furthermore, the "insured" party was entitled to the residual profits of the cell if any profits were allocated to the policyholder surplus of the cell and were available for distribution by Y as policyholder dividends with

respect to that cell.[3] Y would pay the policyholder dividend to a single entity. The policyholder dividend would then be distributed among each of the "insureds" that received "insurance" from the cell.

Retained earnings of each cell were used to offset future operational losses of the cell. If a deficit arose, claim payments to the "insured" parties were reduced accordingly. An "insured" party could not make a policy claim on the assets of Y, other than those assets related to the cell that was the subject of the contract. In addition, losses were limited to the cell's assets (and not to all of Y's assets).

Parent is a Member of X. Parent filed a consolidated income tax return with its subsidiaries in Year 1 and Year 2. Y created Cell 1 to provide "insurance" coverage to any "corporations, subsidiaries, firms or individuals past, present or future or hereafter acquired, organized or controlled" by Parent

In Year 1, it is believed that Parent owned between a Number 3 and Number 4 percent membership interest in X. In Year 2, Parent owned approximately a Number 5 percent membership interest in X. Accordingly, Parent has voting rights in X (as a result of Parent's ownership interest in X). In addition, if X or Y is liquidated, then Parent would receive a portion of the assets upon liquidation.

Sub 1 is a wholly-owned subsidiary of Parent and is a member of Parent's consolidated group. Sub 1 acted as the agent for Parent for executing "insurance" policies with respect to Parent. Policies were executed between Cell 1 and Sub 1, for itself and as an agent for Parent and any "corporations, subsidiaries, firms or individuals past, present or future or hereafter acquired, organized or controlled." Cell 1 is a segregated cell of Y.[4]

The entities that Parent either directly or indirectly owned and that received "insurance" coverage paid their respective portions of their "insurance" premiums. Accordingly, if the entities "insured" by Cell 1 (each an "Insured" and collectively the "Insureds") and owned by Parent either directly or indirectly were entitled to the residual profits of Cell 1 (which were available for distribution by Y as policyholder dividends with respect to Cell 1), then Y would pay the policyholder dividend to a single entity for distribution among each Insured that actually received "insurance" coverage from Cell 1.

For the tax years Year 1 and Year 2, Cell 1 received premiums (from entities that Parent either directly or indirectly owned) in its account for the following lines of insurance:

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[3] A Member of X is not entitled to a cell's surplus.

[4] Sub 1 entered into a participation agreement with Y which provided for the establishment of Cell 1. The participation agreement defines the rights of participants. A participation agreement provides, among other things, for the administration of the insurance program, the purchase of insurance coverage, the allocation of the net profits distributed with respect to the insurance program and identification of persons serving on Y's advisory board.

Lines. Parent either directly or indirectly owned each Insured that received "insurance" coverage. A separate "insurance" policy was issued for each line of "insurance".

None of the Number 1 Insured paid premiums that accounted for more than 15% of the gross premiums received by Cell 1 (for all lines of "insurance" combined) during Year 1. One Insured paid premiums that accounted for Number 2 percent of gross premiums received by Cell 1 (for all lines of "insurance" combined) during Year 2. No other subsidiary paid premiums that accounted for more than 15% of gross premiums received by Cell 1 during Year 2. In both years, several of the subsidiaries are "insured" for risks that account for more than 15% of the total risk "insured" by Cell 1 for particular lines of "insurance." In one case, a single subsidiary accounts for 100% of the risk "insured" by Cell 1 for a particular line of "insurance" in Year 2.

LAW AND ANALYSIS

Insurance company defined: For the purposes of this section, the term "insurance company" has the meaning given such term by section 816(a). IRC § 831(c).

IRC § 816(a): … [T]he term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. IRC § 816(a).

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 because 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). Rev. Rul. 2008-8, 2008-5 IRB 340 (an arrangement that would otherwise be treated as an insurance contract will not fail to be treated as an insurance contract merely because the risks were shifted to a cell of a protected cell company and distributed within that cell).

Issue I

You have asked us to consider whether the revenue agent's aggregation approach (aggregating all coverage with respect to an Insured Group) is correct. The revenue agent has aggregated all premiums paid by the divisions, subsidiaries and disregarded entities owned by the direct subsidiaries of Parent.

Generally speaking, separate entities must be respected as such for tax purposes but may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction. See Moline Properties, Humana. You have indicated that the lower tier subsidiaries are not shams or unreal. Therefore, the insurance activity of lower tier subsidiaries should not be aggregated with the insurance activity of direct subsidiaries of Parent for the purposes of determining risk distribution. The insurance activity of divisions within a taxable entity and the disregarded entities of that taxable entity should be aggregated for the purposes of determining risk distribution. See Rev. Rul. 2005-40 situations 3 and 4.

Issue II

You have asked us to consider whether the risk shifting and risk distribution analysis should be performed for each line of insurance issued by Cell 1 or whether all lines of insurance should be aggregated for this analysis.

We have mentioned homogeneity in several revenue rulings without addressing the relevance of homogeneity as a factor in the subsequent insurance analysis. See Rev. Rul 2002-89, Rev. Rul. 2002-90, Rev. Rul. 2005-40, Rev. Rul. 2008-8. In 2005, we issued a notice asking for comments regarding the relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance. Notice 2005-49, 2005-2C.B. 14. We have not yet published guidance expressing our position on this issue.

Issue III

You have asked us whether the facts indicate that risk was adequately shifted and distributed if each Insured is a brother/sister corporation of Cell 1.

In Rev. Rul. 2002-90, P, a domestic holding company owned all of the stock of 12 domestic operating subsidiaries that operated on a decentralized basis. Together the 12 subsidiaries have a significant volume of independent, homogeneous risks. P, for a valid non-tax business purpose, formed S as a wholly-owned insurance subsidiary. P provides S with adequate capital. S directly insures the professional liability risks of the 12 operating subsidiaries owned by P. S charges the 12 subsidiaries arms-length premiums, which are established according to customary industry rating formulas. There are no parental (or other related party) guarantees of any kind made in favor of S. S does not loan any funds to P or to the 12 operating subsidiaries. In all respects, the parties conduct themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties. S does not provide coverage to any entity other than the 12 operating subsidiaries. None of the operating subsidiaries have liability coverage for less than 5%, nor more than 15%, of the total risk insured by S. S retains the risks that it insures from the 12 operating subsidiaries.

In Rev. Rul. 2005-40, situation 2, X, a domestic corporation, entered into an arrangement with Y, an unrelated domestic corporation, whereby in exchange for an agreed amount of "premiums," Y "insures" X against the risk of loss arising out of its business operations. The amounts Y earns from its arrangements with X constitute 90% of Y's total amounts earned during the taxable year on both a gross and net basis. The arrangement with X accounts for 90% of the total risks borne by Y. Y also enters into arrangements with Z which account for the remaining 10% of amounts earned and risks borne by Y. In this situation, we found that the arrangements between X and Y lack the requisite risk distribution to constitute insurance.

In Rev. Rul. 2008-8, Protected Cell Company is formed by *Sponsor* and 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 Protected Cell Company. 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. In Situation 1, *X*, a domestic corporation is the participant with respect to *Cell X. X* enters into an arrangement, whereby *Cell X* "insures" the professional liability risks of *X. Cell X* does not enter into any arrangements with entities other than *X.* The ruling adopted the rationale of Rev. Rul. 2005-40 and Rev. Rul. 2002-89 and found that 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. In *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. Each subsidiary in the *Y* group enters into an arrangement with *Cell Y* whereby *Cell Y* "insures" the professional liability risks of that subsidiary. None of the subsidiaries have liability coverage for less than 5% more than 15% of the total risk insured by *Cell Y. Cell Y* does not enter into any arrangements with entities other than *Y* or its subsidiaries. Adopting the rationale of Rev. Rul. 2002-90, Rev. Rul 2008-8 found that 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. 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.

You have provided us with extensive information regarding the amount and percentage of premiums paid by each of the "insureds" in the aggregate and for each line of insurance. In several instances, these percentages do not fall within the safe harbor percentages of Rev. Rul. 2002-90. For the purposes of this analysis we will assume that each insured is a brother/sister corporation of Cell 1. You have not asked us to opine on whether the other factors in Rev. Rul. 2002-90 have been met and whether premiums paid are an accurate reflection of the risk insured by Cell 1.

Rev. Rul. 2002-90 provided a framework for insurance analysis where a captive company covered the risks of brother/sister corporations. It provided a safe harbor where at least 12 brother/sister insureds each accounted for no more than 15% and no less than 5% of the covered risk if other factors were satisfied. Rev. Rul. 2002-90 also posited a situation where the captive was covering a large number of independent homogenous risks; however, we have already expressed our inability to offer you advice on the homogeneity issue. Rev. Rul. 2008-8 extended this analysis to cell captives.

If you determine that homogeneity is not a significant factor and that all lines of insurance should be aggregated for the purposes of determining whether there has been sufficient risk shifting and risk distribution, then the facts of the present case (in both years) do not fall into any of the fact patterns where we found a lack of sufficient risk shifting and risk distribution in Rev. Rul. 2005-40.

The facts do not precisely meet the requirements of the safe harbor in Rev. Rul. 2002-90. However, the logical reason for imposing a lower limit on the level of risk insured among 12 sister subsidiaries in the rulings is to exclude situations where fewer than 12 subsidiaries meet the 15% limit and the captive "insurance" company meet the requirement for 12 insured subsidiaries by "insuring" relatively small amounts of risk from other entities (i.e., less than 5%). In Year 1, Number 6 Insureds paid more than 5% and less than 15% of the total premiums received by Cell 1. These Number 6 Insureds paid Number 7% of total premiums paid and the remaining Number 8 Insureds paid the remaining Number 9% of the premiums. In Year 1, Cell 1 has not met the requisite number of subsidiaries with at least 5%; however they have fulfilled the purpose of the 5% threshold. In Year 2, Number 10 Insureds paid more than 5% and all but one paid less than 15% of total premiums received by Cell 1 (one Insured paid Number 11% of total premiums received by Cell 1, which falls outside the safe harbor of 15%). These Number 10 Insureds paid Number 12% of total premiums paid to Cell 1 and the remaining Insureds paid the remaining Number 13%, therefore Cell 1 has fulfilled the purpose of the 5% threshold in Year 2. Accordingly, if you find that homogeneity is not a significant factor, then the facts indicate that the requirements of the safe harbor in Rev. Rul. 2002-90 have been met in Year 1 and have not been met in year 2 (however, the differences in Year 2 are minimal).

If you determine that homogeneity is a significant factor and that all lines of insurance should be analyzed separately for purposes of determining whether there has been sufficient risk shifting and risk distribution, then several lines of "insurance" do not fall within the safe harbor of Rev. Rul. 2002-90. Furthermore, the facts of the case indicate that at least one line of insurance during one of the years under audit, the taxpayer falls into one of the fact patterns where we found a lack of sufficient risk shifting and risk distribution in Rev. Rul. 2005-40.[5]

Issue IV

You have asked us whether the facts indicate that risk was adequately shifted and distributed if Insureds are related to each other but not related to Cell 1.

Under the principles of Rev. Rul. 2008-8, we would either treat Cell 1 as a sibling of the Insureds or as a group captive of the Insureds.

Issue V

You have asked us whether the facts indicate that the risk was adequately shifted and distributed if each Insured is treated as an owner of Cell 1 solely for the purpose of determining whether an insured/policyholder has an equity interest in Cell 1.

[5] The entire Line 1 risk covered by Cell 1 in Year 2 was covering the risk of a single insured.

We have not published guidance on the required level of risk distribution for a group captive among related Insureds.[6] It does not seem appropriate to apply typical parent subsidiary captive criteria where the captive is owned by more than one entity, even if those entities are related to each other. Under the assumed facts of this Issue V we would find it appropriate to apply the analysis of Rev. Rul. 2002-90 and follow the same analysis as we did above under Issue III.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Chris Lieu at (202) 622-3970 if you have any further questions.

/S/

Sheryl B. Flum
Branch Chief, Branch 4
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[6] We have addressed the required level of risk distribution for a group captive where the insureds are unrelated to each other in Rev. Rul. 2002-91.