

Rev. Rul. 2002-89, 2002-52 I.R.B. 984 (12/30/2002)

Part I

Section 162.—Trade or Business Expenses

26 CFR 1.162-1: Business Expenses.

(Also sections 801, 831.)

Captive insurance. This ruling considers circumstances under which arrangements between a domestic parent corporation and its wholly owned insurance subsidiary constitute insurance for federal income tax purposes.

Rev. Rul. 2002-89

ISSUE

Are the amounts paid by a domestic parent corporation to its wholly owned insurance subsidiary deductible as "insurance premiums" under section 162 of the Internal Revenue Code?

FACTS

Situation 1. *P*, a domestic corporation, enters into an annual arrangement with its wholly owned domestic subsidiary *S* whereby *S* "insures" the professional liability risks of *P* either directly or as a reinsurer of these risks. *S* is regulated as an insurance company in each state where *S* does business.

The amounts *P* pays to *S* under the arrangement are established according to customary industry rating formulas. In all respects, the parties conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties.

In implementing the arrangement, *S* may perform all necessary administrative tasks, or it may outsource those tasks at prevailing commercial market rates. *P* does not provide any guarantee of *S*'s performance, and all funds and business records of *P* and *S* are separately maintained. *S* does not loan any funds to *P*.

In addition to the arrangement with *P*, *S* enters into insurance contracts whereby *S* serves as a direct insurer or a reinsurer of the professional liability risks of entities unrelated to *P* or *S*. The risks of unrelated entities and those of *P* are homogeneous. The amounts *S* receives from these unrelated entities under these insurance contracts likewise are established according to customary industry rating formulas.

The premiums *S* earns from the arrangement with *P* constitute 90% of *S*'s total premiums earned during the taxable year on both a gross and net basis. The liability coverage *S* provides to *P* accounts for 90% of the total risks borne by *S*.

Situation 2. Situation 2 is the same as Situation 1 except that the premiums *S* earns from the arrangement with *P* constitute less than 50% of *S*'s total premiums earned during the taxable year on both a gross and net basis. The liability coverage *S* provides to *P* accounts for less than 50% of the total risks borne by *S*.

LAW AND ANALYSIS

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 incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987). 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).

No court has held that a transaction between a parent and its wholly-owned subsidiary satisfies 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. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993); *AMERCO, Inc. v. Commissioner*, 979 F.2d 162 (9th Cir. 1992).

S is regulated as an insurance company in each state in which it transacts business, and the arrangements between *P* and *S* and between *S* and entities unrelated to *P* or *S* are established and conducted consistently with the standards applicable to an insurance arrangement. *P* does not guarantee *S*'s performance and *S* does not make any loans to *P*; *P*'s and *S*'s funds and records are separately maintained. The narrow question presented in *Situation 1* and *Situation 2* is whether *S* underwrites sufficient risks of unrelated parties that the arrangement between *P* and *S* constitutes insurance for federal income tax purposes.

In *Situation 1*, the premiums that *S* earns from its arrangement with *P* constitute 90% of its total premiums earned during the taxable year on both a gross and a net basis. The liability coverage *S* provides to *P* accounts for 90% of the total risks borne by *S*. No court has treated such an arrangement between a parent and its wholly-owned subsidiary as insurance. To the contrary, the arrangement lacks the requisite risk shifting and risk distribution to constitute insurance for federal income tax purposes.

In *Situation 2*, the premiums that *S* earns from its arrangement with *P* constitute less than 50% of the total premiums *S* earned during the taxable year on both a gross and a net basis. The liability coverage *S* provides to *P* accounts for less than 50% of the total risks borne by *S*. The premiums and risks of *P* are thus pooled with those of the unrelated insureds. The requisite risk shifting and risk distribution to constitute insurance for federal income tax purposes are present. The arrangement is insurance in the commonly accepted sense.

HOLDINGS

In *Situation 1*, the arrangement between *P* and *S* does not constitute insurance for federal income tax purposes, and amounts paid by *P* to *S* pursuant to that arrangement are not deductible as "insurance premiums" under section 162.

In *Situation 2*, the arrangement between *P* and *S* constitutes insurance for federal income tax purposes, and the amounts paid by *P* to *S* pursuant to that arrangement are deductible as "insurance premiums" under section 162.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 2001-31, 2001-1 C.B. 1348, is amplified.

DRAFTING INFORMATION

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