

INTERNAL REVENUE SERVICE

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National Director of Appeals
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Assistant Chief Counsel
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Your request for Technical Assistance
SPR-100913-99

This responds to your request for technical assistance regarding your proposal to make a full concession to the taxpayer on a captive insurance issue contrary to the Service's published position in Rev. Rul. 77-316, 1977-2 C.B. 53, amplified and clarified by Rev. Rul. 88-72, 1988-2 C.B. 31, clarified by Rev. Rul. 89-61, 1989-1 C.B. 75. This document is not binding upon Appeals. See IRM 8.14.1.4. It is not to be cited as precedent.

LEGEND:

- Taxpayer =
- State A =
- Year 1 =
- Year 2 =
- Year 3 =
- Year 4 =
- Year 5 =
- Individual B =
- Captive =
- Foreign Country C =
- W =
- X =
- Y =
- Z =

ISSUE

Whether the amounts paid by Taxpayer covering its liability on extended service contracts are deductible insurance premiums?

CONCLUSION

Given the facts and circumstances presented, we do not object to the full concession of the captive insurance company issue in this case.

FACTS

Taxpayer is an automobile dealership incorporated in State A. During tax years under consideration (Year 1, Year 2, Year 3, Year 4 and Year 5), Taxpayer sold automobile service contracts in conjunction with its sales of automobiles. All of the stock of Taxpayer is owned by Individual B.

Captive was formed as an insurance company under the laws of Foreign Country C. All of the stock of Captive was owned by Individual B.

Taxpayer paid amounts for its coverage on its extended service contracts to third party administrator which took a service charge and then payments were made to a third party insurance company which took another fee. Finally, Captive received premiums for assuming risks under Taxpayer's extended service contracts. Your request for technical assistance and additional information provided indicates that Captive also received substantial premium income from reinsuring unrelated risks. For the years in question the percentage of unrelated risks are as follows:

Taxable Year	Percentage of Insurance Business with Unrelated Parties
1991	<u>w</u> %
1992	<u>x</u> %
1993	<u>x</u> %
1994	<u>y</u> %
1995	<u>z</u> %

Based on the substantial amount of unrelated business written by Captive, and several appellate court decisions, you are recommending that the captive issuance issue be fully conceded.

LAW AND ANALYSIS

Neither the Internal Revenue Code nor the regulations define the terms "insurance" or "insurance contract." Under case law, an insurance contract has been defined 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." Epmeier v. United States, 199 F.2d 508, 509-510 (7th Cir. 1952).

For federal income tax purposes the principal definition of insurance was announced by the Supreme Court in Helvering v. LeGierse, 312 U.S. 539 (1941). There, the Court explained that insurance involves "risk-shifting and risk-distributing."

Rev. Rul. 77-316 addresses three situations in which a domestic corporation and its domestic subsidiaries paid amounts designated as insurance premiums to the parent's wholly owned foreign "insurance" subsidiary. This insurance subsidiary never "insured" any risks of parties other than the parent (X) and its domestic subsidiaries. In Situation 1, the parent and its subsidiaries paid amounts directly to the insurance subsidiary. In Situation 2, the parent

and its subsidiaries paid premiums to M, an unrelated domestic insurance company. Then, through a previous contractual arrangement, M immediately transferred 95% of the risks to the parent's insurance subsidiary, in a reinsurance transaction. In Situation 3, the parent and its subsidiaries paid amounts directly to the insurance subsidiary and the insurance subsidiary transferred 90% of the risks to W, an unrelated insurance company, in a reinsurance transaction. Regarding these situations, Rev. Rul. 77-316 concluded the following:

To the extent that the risks of loss are not retained in their entirety by (as in Situation 1) or reinsured with (as in Situation 3) insurance companies that are unrelated to the economic family of insurers, there is no risk-shifting or risk-distributing, and no insurance, the premiums for which are deductible under § 162 of the Code.

Rev. Rul. 77-316 held that the amounts paid by parent and its domestic subsidiaries in the three situations were not deductible to the extent that unrelated parties did not bear the risk under the contracts. Thus, nothing was deductible in Situation 1, only 5% of the amounts paid were deductible in Situation 2 and 90% of the amounts paid were deductible in Situation 3.

In Rev. Rul. 88-72, as clarified by Rev. Rul. 89-61, a parent corporation and its domestic subsidiaries purchased "insurance" policies from the parent's wholly owned insurance subsidiary. This insurance subsidiary was engaged in the business of selling insurance policies to the public at large, not just the parent and related parties. Stating that "the presence of third party insureds is immaterial to whether risk shifting exists," Rev. Rul. 88-72 held that the parent and its subsidiaries could not deduct the "premiums" that they paid to the parent's insurance subsidiary.

Subsequent court decisions involving facts similar to the situations in Rev. Rul. 77-316 have held that payments made by a parent (or its subsidiaries) to a wholly owned insurance captive are not deductible under § 162 because risk of economic loss is not shifted away from the parent (or its subsidiaries). See, e.g., Gulf Oil Corp. v. Commissioner, 914 F.2d 396 (3rd Cir. 1990); Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987); Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1986); Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985); Mobil Oil Corp v. United States, 8 Cl Ct. 555 (1985) Cf. Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981), cert. denied, 454 U.S. 965 (1981).

On the other hand, there has been a recent trend among appellate courts in the captive insurance area to hold that the presence of unrelated risks creates risk distribution, which, in turn, results in the ability of related parties to shift the risk of loss to their captive insurance subsidiaries. See Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858 (7th Cir. 1992); The Harper Group v. Commissioner, 979 F.2d 1341 (9th Cir. 1992); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992). In these decisions, the amount of unrelated risks ranged from 29 percent to 99.75 percent. In addition, the Court of Appeals for the Federal Circuit affirmed the Claims Court's decision in Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135 (Fed. Cir. 1993), aff'g, 24 Cl.Ct. 714 (1991), which had held in favor of the taxpayer in a captive insurance arrangement involving 44 percent unrelated risks.

HAZARDS AND OTHER CONSIDERATIONS

Accordingly, we do not object to the full concession of the captive insurance issue in this case.

If you have any questions about this memorandum, please call (202) 622-3970.

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By: SIGNED BY DONALD J. DREES
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