

COMPLIANCE UPDATE

IRS Revenue Ruling 2002-90

Do amounts paid for professional liability coverage by a number of operating subsidiaries to an insurance subsidiary of a common parent constitute insurance premiums for federal income tax purposes?



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IRS REVENUE RULING 2002-90**SECTION 162.—TRADE OR BUSINESS EXPENSES**

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

Captive insurance. This ruling considers under which payments for professional liability coverage by a number of operating subsidiaries to an insurance subsidiary of a common parent constitute insurance for federal income tax purposes.

Rev. Rul. 2002-89

ISSUE

Are the amounts paid for professional liability coverage by domestic operating subsidiaries to an insurance subsidiary of a common parent deductible as "insurance premiums" under section 162 of the Internal Revenue Code.

FACTS

P, a domestic holding company, owns all of the stock of 12 domestic subsidiaries that provide professional services. Each subsidiary in the *P* group has a geographic territory comprised of a state in which the subsidiary provides professional services. The subsidiaries in the *P* group 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 *P* group. Together the 12 subsidiaries have a significant volume of independent, homogeneous risks.

P, for a valid non-tax business purpose, forms *S* as

a wholly-owned insurance subsidiary under the laws of State C. *P* provides *S* adequate capital and *S* is fully licensed in State C and in the 11 other states where the respective operating subsidiaries conduct their professional service businesses. *S* directly insures the professional liability risks of the 12 operating subsidiaries in the *P* group. *S* charges the 12 subsidiaries arms-length premiums, which are established according to customary industry rating formulas. 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. 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.

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).

In *Humana*, the United States Court of Appeals for the Sixth Circuit held that arrangements between a parent corporation and its insurance company subsidiary did not constitute insurance for federal income tax purposes. The court also held, however, that arrangements between the insurance company subsidiary and several dozen other subsidiaries of the parent (operating an even larger number of hospitals) qualified as insurance for federal income tax purposes because the requisite risk shifting and risk distribution were present. *But see Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995) (concluding the lack of a business purpose, the undercapitalization of the offshore captive insurance subsidiary and the existence of related party guarantees established that the substance of the transaction did not support the taxpayer's characterization of the transaction as insurance). In

Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42 (1997), the United States Court of Federal Claims concluded that an arrangement between the captive insurance subsidiary and each of the 100 operating subsidiaries of the same parent constituted insurance for federal income tax purposes. As in *Humana*, the insurer in *Kidde* insured only entities within its affiliated group during the taxable years at issue.

In the present case, the professional liability risks of 12 operating subsidiaries are shifted to *S*. Further, the premiums of the operating subsidiaries, determined at arms-length, are pooled such that a loss by one operating subsidiary is borne, in substantial part, by the premiums paid by others. The 12 operating subsidiaries and *S* conduct themselves in all respects as would unrelated parties to a traditional insurance relationship, and *S* is regulated as an insurance company in each state where it does business. The narrow question presented is whether *P*'s common ownership of the 12 operating subsidiaries and *S* affects the conclusion that the arrangements at issue are insurance for federal income tax purposes. Under the facts presented, we conclude the arrangements between *S* and each of the 12 operating subsidiaries of *S*'s parent constitute insurance for federal income tax purposes.

HOLDING

The amounts paid for professional liability coverage by the 12 domestic operating subsidiaries to *S* are "insurance premiums" deductible under section 162.

EFFECT ON OTHER DOCUMENTS

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

DRAFTING INFORMATION

The principal author of this revenue ruling is

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RESOURCES

ONLINE SUPPORT INFORMATION

Customers may access support information related to captive insurance on rmcgp.com/user

IMPORTANT KNOWLEDGE-BASED ARTICLES

New knowledge-based articles have been posted online to assist with captive insurance questions, as well as other areas of interest, including:

- Retirement
- Insurance
- Self-Insurance
- Risk Management
- Employee Benefits
- Health & Welfare Plans

INFORMATION ON ADMINISTRATIVE & CONSULTING SERVICES

For more information about RMC Group's Administrative and Consulting Services, there are three easy ways to contact us:

web: www.rmcgp.com/products-services

email: rmc@rmcgp.com

call: 888.599.5553

INDUSTRY RESOURCES & GENERAL GUIDELINES

For more industry information and general guidelines on captive insurance:

Captive Insurance Companies Association (CICA):

www.cicaworld.com/Resources.aspx

Self-Insurance Institute of America (SIIA):

www.siaa.org/i4a/doclibrary/

The Risk Management Society (RIMS):

www.rims.org/resources/ERM/Pages/default.aspx

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