Defining Insurance for Federal Income Tax Purposes: Facts and Circumstances Are the Key

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Captive insurance companies have long been used by businesses to insure related party risks. The Internal Revenue Service (IRS) has vigorously scrutinized and sometimes challenged captives. In an attempt to provide parameters for captive insurance arrangements to be treated as insurance companies for federal income tax purposes, the IRS and the U.S. Department of Treasury (Treasury) have issued a variety of guidance. For the past several years, the government has focused its challenges on so-called "micro captives" that have elected special tax treatment under Code Sec. 831(b).[1] This article discusses the importance of considering all facts and circumstances for each individual captive arrangement to determine if that captive should be taxed as an insurance company.

Background

Captive insurance companies are generally formed as subsidiaries to insure the risks of the businesses that are related to them. Companies that create captives span from large corporations with hundreds of subsidiaries to small closely held businesses. Captive insurance companies have been used by business owners for many reasons. For example, captives allow businesses to obtain coverage for risks that may otherwise not be available from commercial carriers. When commercial insurance is available, but the coverage is prohibitively expensive, a captive can issue policies at lower premiums. Insuring with a captive can be more effective than commercial insurance because a captive's coverage is customizable, and the insured has greater control over the coverage terms. Additionally, by insuring with a captive, an insured pays its premiums as usual, but rather than those premiums going to an unrelated party, they stay within the same corporate group and, in that regard, the insured gets the best of both worlds. Captives also allow access to the reinsurance market. Lastly, there are tax benefits to using captives.

Captives with no more than $2.65 million (micro captives) in annual net written premiums may elect under Code Sec. 831(b) to pay tax on their annual

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investment returns rather than on their premium income.[2] Some micro captives have been used by businesses strictly for tax avoidance and not to support the risks of the business. In Notice 2016-66,[3] the government identified micro captives as transactions of interest. The government has challenged many of these arrangements, and it has prevailed in several U.S. Tax Court cases.[4] There have also been indications that some of the micro captives that have been challenged are, in reality, qualified insurance companies.[5]

Insurance for Income Tax Purposes

The Code defines an insurance company as "any company more than half the business of which during the taxable year is the issuing of insurance contracts or annuity contracts or the reinsuring of risks underwritten by insurance companies."[6] This is essentially a two-part test for determining the status of an insurance company. First, the company must be engaged in the business of issuing contracts that are insurance or reinsurance contracts for U.S. federal income tax purposes. Second, the issuance of insurance contracts or reinsurance contracts must represent more than half of the company's business. However, neither the Code nor the Treasury regulations thereunder define the terms "insurance" or "insurance contracts." The courts have set forth a few main characteristics of insurance, which are generally used to define whether a particular arrangement is one of insurance for federal income tax purposes.

The regime governing the federal income taxation of captive insurers traces back to principles first articulated in *Helvering v. Le Gierse*.[7] In that case, the U.S. Supreme Court observed that "Historically and commonly insurance involves risk-shifting and risk-distributing .... That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators."[8] These two concepts—risk shifting and risk distribution—are at the core of most discussions regarding the taxation of captive insurers. Each of these elements must be present for the insurance relationship to be respected for income tax purposes. If either risk shifting or risk distribution is not present, the insurance arrangement will not be respected, and the insured's premium payment may instead be characterized as a deposit, a loan, a contribution to capital, or an indemnity arrangement other than an insurance contract.

The Second Circuit further differentiated risk shifting and risk distribution in *Commissioner v. Treganowan*,[9] stating:

> Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and insured each of whom gamble on the time the [insured event will occur]. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its cost throughout a group. By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance.[10]

Risk shifting generally occurs when one company no longer bears the economic risk of loss (*e.g.*, when an insurance contract shifts the risk of loss from the insured to the insurer). Risk shifting may not occur if an entity was not at risk for loss (*e.g.*, because of a guarantee) or if the risk of loss remained with the entity (*e.g.*, because the insurer had no ability to pay claims). Risk distribution may occur if there are a large number of statistically independent risks.

A variety of court cases have added the additional requirements that transferred risk must be an insurance risk and that it must be considered insurance in the commonly accepted sense in order for an arrangement to constitute insurance for federal income tax purposes.[11]

Recently, in *Avrahami v. Commissioner*,[12] Reserve *Mechanical Corp v. Commissioner*,[13] *Syzygy v. Commissioner*,[14] and *Caylor Land & Development v. Commissioner*,[15] the Tax Court detailed nine nonexclusive factors to consider whether a captive was a *bona fide* insurance company operating with the commonly accepted notions of insurance:

- whether it was created for legitimate nontax reasons;
- whether there was a circular flow of funds;
- whether the entity faced actual and insurable risk;
- whether the policies were arm's-length contracts;
- whether the entity charged actuarially determined premiums;
- whether comparable coverage was more expensive or even available;
- whether it was subject to regulatory control and met minimum statutory requirements;
- whether it was adequately capitalized; and
- whether it paid claims from a separately maintained account.

The IRS' Approach to Captives

The IRS has a storied history of challenging all sorts of captive arrangements. The following is an abbreviated history of the IRS' evolving positions on whether captive insurance companies can be taxed pursuant to Subchapter L.

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Economic Family Theory

In the early 1970s, the IRS began attacking captive insurance arrangements using the "economic family" theory.[16] The economic family theory asserted that insurance arrangements between a parent and a wholly owned insurance subsidiary did not constitute insurance for federal income tax purposes, because the corporate group, considered as a whole, had neither shifted risk nor distributed risk outside the group. The economic family theory rested on the assumption that a corporate parent has effective control over the assets and liabilities of its direct and indirect subsidiaries. This theory stood in tension with the long-standing tax principle—most plainly stated in *Moline Properties v. Commissioner*—that the tax law generally respects corporate forms.[17]

For several years after establishing the economic family theory, the IRS generally succeeded in challenging captive insurers, although not necessarily on its economic family argument.[18] In general, the decisions from that period focused on whether a parent effectively shifted the risk of loss to its wholly owned insurance subsidiary, using the risk-shifting and risk-distribution concepts from *Le Gierse* as the touchstone for their analyses.[19]

For instance, in *Carnation Co. v. Commissioner*,[20] the Tax Court held that a wholly owned insurance subsidiary did not enter into an insurance arrangement with its parent for tax purposes because the arrangement did not shift or distribute risk, citing *Le Gierse*. The Tax Court said it would have reached the same conclusion whether or not the captive insurer was part of the same corporate group, implicitly dismissing the IRS' economic family theory. In addition, in *Clougherty Packing Co. v. Commissioner*,[21] the Tax Court explicitly disclaimed the IRS' economic family theory and focused instead on the substance of the transaction. Following the decisions denouncing the economic family theory in *Carnation Co. v. Commissioner* and *Clougherty Packing Co. v. Commissioner*, the IRS abandoned the economic family theory.[22]

Safe Harbors

Starting in 2002, the IRS and Treasury published several revenue rulings to set parameters for captive insurance companies to meet to be considered insurance for federal tax purposes. The IRS then used the standards set forth in these rulings to challenge captive arrangements.

Rev. Rul. 2002-89[23]

In Rev. Rul. 2002-89, the IRS addressed two situations in which a parent corporation insured its risks with a wholly owned insurance company, which also insured the risks of unrelated third parties. The insurance subsidiary was a U.S. corporation, licensed and regulated in each state in which it did business, and the risks of the unrelated third parties were homogenous with the parental risks. The primary difference between the two captives was in the amount of unrelated business each captive undertook. For the first captive, the parent accounted for 90 percent of premium income and 90 percent of the risk borne by the captive. For the second captive, the parent accounted for less than 50 percent of premium income and less than 50 percent of the total risk borne by the captive. According to the ruling, the presence of merely 10 percent of premiums from parties other than the captive's parent was insufficient to create the necessary risk shifting and risk distribution, while 50 percent of non-parental risk was sufficient. Rev. Rul. 2002-89 may be read as establishing a "safe harbor" for arrangements whereby a captive may issue insurance covering the parental risk of less than 50 percent of premiums. But the ruling also cautions that if insurance with parental risk makes up 90 percent or more of premiums, the captive will not be respected as an insurance company for federal income tax purposes.[24]

Rev. Rul. 2002-90[25]

In Rev. Rul. 2002-90, the IRS addressed a situation in which the captive provided insurance to various sister companies. The arrangement in the revenue ruling consists of a parent corporation owning 12 operating subsidiaries that rendered professional services. The 12 subsidiaries had a significant volume of independent, homogenous risks. The captive insured the risks of the operating subsidiaries on a commercially reasonable basis. None of the subsidiaries provided less than five percent or more than 15 percent of the risks insured. The IRS concluded in the revenue ruling that adequate risk shifting and risk distribution were present between the captive and the sister companies.

Rev. Rul. 2002-91[26]

In Rev. Rul. 2002-91, the IRS addressed an arrangement involving a group captive formed by a relatively small group of unrelated businesses involved in a highly concentrated industry to provide insurance coverage. Each of the insureds in the group had no more than 15 percent of the ownership of, or vote of, the group captive, and none accounted for more than 15 percent of the risk. On these facts, the IRS concluded that adequate risk shifting and risk distribution were present.

Rev. Rul. 2005-40[27]

The IRS subsequently concluded in Rev. Rul. 2005-40 that an arrangement with an entity that insures the risks of only one policyholder does not qualify as insurance for tax

purposes because the risks are not distributed among other policyholders. The ruling also explains how this conclusion applies to single-member limited liability companies, which in some cases are treated as entities separate from their owners and in other cases are disregarded. The IRS ruled that to extent that a single-member limited liability company is a disregarded entity, such a disregarded entity cannot be considered for purposes of risk distribution. Thus, risk distribution is lacking and the transaction would not be considered "insurance".

Judicial Decisions—Risk Shifting and Risk Distribution

Nearly 10 years ago, the IRS challenged several arrangements that did not meet the safe harbors set forth in the revenue rulings. Notwithstanding Rev. Ruls. 2002-89, 2002-90, 2002-91, and 2005-40, the courts have continued to take a facts-and-circumstances approach when analyzing whether a particular captive arrangement should be treated as insurance for federal income tax purposes. Specifically, in *Rent-A-Center v. Commissioner*[28] and *Securitas Holdings, Inc. v. Commissioner*,[29] the Tax Court considered various aspects of the safe harbors set forth in the aforementioned revenue rulings, but ultimately ruled that the determination of risk shifting and risk distribution are based on facts and circumstances.

Rent-A-Center v. Commissioner

In 2014, the Tax Court decided a significant captive case focused on whether risk was shifted and distributed between brother–sister entities. The parent, Rent-A-Center ("RAC"), formed a wholly owned entity in Bermuda, Legacy, to function as an insurer for the RAC group. In total, the RAC group was composed of approximately 15 subsidiaries that operated in all 50 states. During the years at issue, RAC operated between 2,600 and 3,000 stores, employed between 14,300 and 19,700 employees, and operated between 7,100 and 8,000 vehicles. Legacy entered into arm's-length contracts with, collected premiums from, and paid claims to entities within the RAC group with respect to various risks, including workers' compensation, automobile, and general liability. Legacy did not possess an ownership interest in any of the subsidiaries.

In order to meet certain minimum capitalization requirements, Legacy initially had several classes of assets. First, RAC guaranteed certain liabilities of Legacy. RAC made no payments under the guaranty, however, and revoked the guaranty when it was no longer needed. Second, with the permission of the regulatory authority, Legacy recorded deferred tax assets with respect to the insurance policies it wrote as part of its general business assets. Third, Legacy purchased treasury stock from RAC, which Legacy was also permitted to include as part of its general business assets.

After considering the separate corporate forms of Legacy and other members of the RAC group, and after conducting a net worth analysis, the majority of the court found that the Legacy policies shifted risk from other subsidiaries to Legacy. The Tax Court also found that, under the facts of the case, the parental guaranty did not eliminate risk shifting because the guaranty served no other purpose than to meet local law requirements. Further, no payments were made pursuant to the parental guaranty, so the court concluded that the guaranty did not shift the ultimate risk of loss. Finally, considering all of Legacy's business assets, including the premiums received, the deferred tax assets, and the treasury stock, Legacy was not undercapitalized.

Additionally, the majority of the court found that the wholly owned captive insurance company insured a sufficient number of statistically independent risks from related entities considering the diversity of risks assumed (*e.g.*, workers' compensation, automobile, and general liability) as well as the number of insured risks (*e.g.*, more than 14,000 employees, more than 7,000 vehicles, and more than 2,600 stores).

Despite having a number of facts different from the aforementioned revenue rulings (*e.g.*, the presence of a parental guaranty), the majority opinion for the Tax Court made little mention of the rulings and instead chose to analyze the arrangement using the same facts-and-circumstances approach that has been used in the insurance tax area for decades.

Securitas Holdings, Inc. v. Commissioner

Shortly after the decision was entered into in the *Rent-A-Center* case, the Tax Court concluded in *Securitas Holdings, Inc. v. Commissioner* that risk may be shifted and distributed between related entities. This case is another good example of the Tax Court considering facts and circumstances for insurance qualifications, instead of relying on IRS' bright-line rules provided by the revenue rulings.

Securitas was the U.S. parent of an affiliated group of U.S. corporations. Securitas also owned Protectors Insurance Company of Vermont ("Protectors"), a Vermont licensed captive insurance company, which insured the various risks of sister entities within the Securitas group. Examples of insured risks included workers' compensation, automobile, employment practices, general, and fidelity liabilities. Additionally, Securitas AB formed

Securitas Group Reinsurance Limited ("SGRL"), which reinsured U.S. risks insured by Protectors as well as non-U.S. risks insured by another entity. Both Protectors and SGRL entered into arm's-length contracts with, collected premiums from, and paid claims to entities within the Securitas group. Neither Protectors nor SGRL possessed an ownership interest in any of the companies for which they insured risks. In order to protect the tax-exempt status of a member of the Securitas group, Securitas provided a parental guaranty to Protectors. Securitas never made any payments under the guaranty.

At the beginning of 2003, the Securitas group consisted of 11 subsidiaries. During 2003, several of these subsidiaries merged such that only four subsidiaries remained by 2004. During 2003 and 2004, the years at issue, Protectors issued policies that covered the risks of more than 100,000 people in the U.S. who operated more than 2,250 vehicles. Most of this risk was concentrated in a small number of entities: in 2003, four entities represented more than 90 percent of the premiums paid to Protectors, and in 2004, one entity represented nearly 90 percent of the premiums paid to Protectors. Additionally, SGRL, which reinsured Protectors' risks detailed above, also reinsured the risk of more than 200,000 people who worked for more than 25 separate entities in more than 20 countries.

After considering the separate corporate forms of Protectors, the other members of the Securitas group, and SGRL, the court found that risks were shifted from the members of the Securitas group to Protectors and then to SGRL.[30] The court also found that, under the facts of the case, the parental guaranty did not eliminate risk shifting because the guaranty served no other purpose than to preserve the tax-exempt status of the Securitas group member. Further, no payments were made pursuant to the parental guaranty, the guaranty did not shift the ultimate risk of loss, and Securitas was not undercapitalized.

Additionally, the *Securitas* court found that the wholly owned captive insurance company and the related reinsurance company satisfied the risk-distribution requirements. Unlike Rev. Ruls. 2002-90 and 2009-89 discussed above, the court did not measure risk distribution by the number of legal entities insured or the concentration of risk per entity. Instead, the court looked at the overall number of risks:

> Risk distribution is viewed from the insurer's perspective. As a result of the large number of employees, offices, vehicles, and services provided by the U.S. and non-U.S. operating subsidiaries, SGRL was exposed to a large pool of statistically independent risk exposures. This does not change merely because multiple companies merged into one. The risks associated with those companies did not vanish once they all fell under the same umbrella. As the [Securitas] Group' expert … explained in his expert report: "It is the pooling of exposures that brings about the risk distribution—who owns the exposures is not crucial." We agree and find that by insuring the various risks of U.S. and non- U.S. subsidiaries, the captive arrangement achieved risk distribution.[31]

In *Securitas*, Protectors (and SGRL) insured a sufficient number of statistically independent risks from related entities considering the diversity of risks assumed (*e.g.*, workers' compensation, automobile, employment practice, fidelity, and general liabilities) as well as the number of insured risks (*e.g.*, more than 100,000 people and more than 2,250 vehicles). Accordingly, the arrangement in *Securitas* was found to be one of insurance for federal income tax purposes using a facts-and-circumstances analysis, even though the arrangement did not fit neatly into the facts of the captive revenue rulings.

Homogeneity and Related-Party Loans

The safe harbors set forth in the above-discussed revenue rulings did not consider all aspects of the determination of whether a captive is an insurance company for federal tax purposes. When discussing the safe harbor scenarios provided in the revenue rulings, the IRS assumed there were no related party loans and that the risks were homogenous in all the fact patterns. However, the rulings did not discuss the significance of these facts.

> *Therefore, from a policy perspective, the analysis used to determine whether a captive arrangement is an insurance for federal tax purposes should remain a facts-and-circumstances test.*

After the revenue rulings were issued, the IRS and Treasury issued Notice 2005-49.[32] That notice requested comments on additional guidance concerning the

standards for determining whether an arrangement constitutes insurance for federal income tax purposes. Specifically, the Notice requested comments on certain issues that could arise in captive arrangements, including circumstances under which the qualification of an arrangement between related parties as insurance may be affected by a loan back of amounts paid as "premiums" as well as the relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance for federal income tax purposes.[33] These two points are discussed further below.

Homogeneity

Rev. Ruls. 2002-89, 2002-90, and 2005-40 each state that the risks assumed by the captive are homogenous. Prior to the issuance of those rulings, the IRS had taken the position in field service advice (FSA) 1998-578[34] that unrelated premiums do not provide risk distribution when they arise from a different line of business than the related premiums. However, in Rev. Rul. 60-275, the IRS concluded that risk distribution did not occur because the risks were homogenized or concentrated in a particular geographic area.[35] Although the IRS cites the presence of homogeneous risk as a favorable fact for insurance company status in the rulings discussed above, it is not entirely clear why homogeneous risks should always be preferable.

While bright-line rules may seem useful in providing clarity and certainty when analyzing federal income tax issues, captive arrangements are too numerous and unique to each situation for such rules to work effectively.

Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. 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.[36] Commercial insurers often offset risks in this line of business with risks in other lines to smooth out risks. In *Securitas Holdings, Inc. v. Commissioner*,[37] the court concluded that there was sufficient risk distribution considering the diversity of risks assumed as well as the number of insured risks.

However, it is worth noting that underwriting different types of risks requires different knowledge and expertise. Captives, by virtue of insuring risks from their parent and sister companies from the same group and industry, have unique knowledge and expertise regarding their parents' and sisters' risks and the management of those risks. A strong benefit of homogeneity of insurance risks with respect to captives is that it helps to ensure that the captive stays within its area of knowledge and expertise.

Large numbers of homogeneous risks insured may be relevant to achieving risk distribution when the diversity of risk exposure is not available, but it should probably not be a necessary condition of risk distribution. If the IRS requires homogeneity for an arrangement, it may adversely affect an arrangement's risk distribution because risks may be too concentrated in one or two lines of business or a certain geographic area. On the other hand, if the IRS requires a lack of homogeneity for an arrangement to qualify as insurance, that determination would provide a significant incentive for captives to go outside their areas of expertise and into areas of traditional insurance. Homogeneity can be allowed but should not be required in the determination of risk distribution. The determination of risk distribution should depend on specific facts and circumstances; bright-line rules may provide an inappropriate incentive for captives to obtain certain arrangements that, in turn, may not benefit (if not harm) risk distribution.

Related-Party Loans

Rev. Ruls. 2002-89, 2002-90, and 2005-40 each state in their fact pattern that the insurance company does not loan any money to its affiliates. The significance of the lack of related-party loans is not addressed in the rulings; thus, it is not entirely clear how a loan back would impact the federal income tax treatment of the arrangement. There seems to be little in the way of helpful authorities that directly addressed loan backs from a captive to its parent company. In *Mobil Oil Corp. v. United States*,[38] the parent company owned two insurance companies that lent money to and invested in the affiliates of the parent company. While the court cited the loan backs as evidence of the lack of risk shifting, even if there were no loan backs, the court made it clear that the arrangement would not have been respected as insurance at that time. This was one of the earliest captive insurance cases where parent involvement was often viewed unfavorably.

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In FSA 199945009,[39] the IRS Office of Chief Counsel (National Office) agreed with the field's recommendation to concede a captive insurance case. In this FSA, the National Office noted two factors that, had they been more fully developed, might be relevant if the field had wanted to challenge the transactions. One such factor was that a significant portion of the premiums was paid from the captive insurance company to a sister finance company. The sister company was not insured by the captive insurance company. The National Office stated:

> Depending upon the facts of a particular case, the presence of circular flows of cash may indicate self-dealing and could undermine a taxpayer's argument that the captive insurer was an independent entity that negotiated the terms of the 'insurance' transactions at arm's length. Since the facts concerning these loans between C (the captive insurance company) and H (the sister finance company) are not clear, we cannot determine whether the resulting circular cash flows affect whether the transactions at issue are 'insurance'.[40]

In this FSA, the National Office provided a general caution against a circular flow of funds but did not directly address parental loans.

The insurance company's lending and investment decisions should be independent of establishing risk shifting and risk distribution. An argument could be made that, if all terms and conditions of the loan are the same as if the parties were unrelated and engaged in an arm's-length transaction, the loan should be respected and considered separate from insurance qualification. In addition, a commenter to Notice 2005-49 proposed a few factors for the IRS to consider in evaluating whether an insurance company's loan backs have undermined the insurance arrangement: (1) whether the loans represent *bona fide* indebtedness, which is enforceable by their terms and which contains commercially reasonable terms; (2) whether the loans are permitted by the statutes or regulatory authorities of the insurance company's domicile; (3) whether the timely repayment of the indebtedness, together with the insurance company's other resources, permits the insurance company to meet its anticipated liquidity needs; and (4) taking into account the solvency of, and security (if any) provided by, the debtor, it is commercially reasonable to expect the loans to be repaid in accordance with their terms.[41] Guidance incorporating these factors in determining the appropriate use of loan backs in captive arrangements, essentially implementing a facts-and-circumstances approach to analyzing loan backs, could be helpful. However, nothing to date has been published in response to the comments received pursuant to Notice 2005-49.

Conclusion

It is undeniably easier to determine the tax classification of an entity when there are specific parameters that can be applied. However, in the case of defining captive insurance companies as taxable insurance companies, bright-line rules do not seem helpful. The IRS attempted to put some parameters around captive insurance arrangements when it issued a series of revenue rulings between 2002 and 2005. Unless and until these rulings are withdrawn by the government, they are the government's official litigating position. However, these rulings have some serious limitations in that they do not cover all aspects to be considered in analyzing a captive insurance arrangement to determine the appropriate tax treatment. Consequently, the courts have continued to analyze captives using a facts-and-circumstances test.

> *As long as the concept of what constitutes insurance for federal income tax purposes remains a facts-and-circumstances test, so too should captive insurance arrangements.*

We believe these revenue rulings may inadvertently create incentives for some taxpayers to attempt to design their business strictly for the purposes of meeting the safe harbors even if in reality the business does not operate as designed. As has been borne out by a number of captive cases like *Rent-A-Center* and *Securitas*, the safe harbors do not always take into consideration the true economics of a captive insurance arrangement and may discourage taxpayers that may benefit from captives from using them. On the other hand, trying to implement guidance that takes into account the wide and ever-changing variety of captive arrangements in use while imposing bright-line tests would cost the government tremendous effort and likely still could not take into account the changing landscape of the captive world.

Therefore, from a policy perspective, the analysis used to determine whether a captive arrangement is an insurance for

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federal tax purposes should remain a facts-and-circumstances test. While bright-line rules may seem useful in providing clarity and certainty when analyzing federal income tax issues, captive arrangements are too numerous and unique to each situation for such rules to work effectively. As long as the concept of what constitutes insurance for federal income tax purposes remains a facts-and-circumstances test, so too should captive insurance arrangements.

ENDNOTES

* The following information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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[1] Unless otherwise indicated, all references to "Code Sec." are to the Internal Revenue Code of 1986, as amended.

[2] Code Sec. 831(b). For taxable years beginning in 2023, under Code Sec. 831(b)(2)(A)(i), the amount of the limit on net written premiums or direct written premiums (whichever is greater) is $2,650,000 to elect the alternative tax for certain small companies under Code Sec. 831(b)(1) (*i.e.*, the election to be taxed only on taxable investment income). Rev. Proc. 2022-38, §3.36, IRB 2022-45, 445.

[3] IRB 2016-47, 745.

[4] *See, e.g.*, *Avrahami*, 149 TC 144, Dec. 60,991 (2017); *Syzygy*, 117 TCM 1165, Dec. 61,443(M), TC Memo. 2019-34; *Caylor Land & Dev't*, 121 TCM 1205, Dec. 61,837(M), TC Memo. 2021-30.

[5] *See, e.g.*, *Puglisi*, TC Dkt. No. 4796-20 (Nov. 5, 2021).

[6] Code Sec. 816(a)(2). Code Sec. 831(c) references the definition of an insurance company in Code Sec. 816(a). A company is taxed as an insurance company under Subchapter L of the Code if it meets the definition of an insurance company under either Code Sec. 816(a) for life insurance companies taxed under Part I of Subchapter L or Code Sec. 831(c) for nonlife insurance companies taxed under Part II of Subchapter L.

[7] *Helvering v. Le Gierse*, SCt, 41-1 USTC ¶10,029, 312 US 531, 61 SCt 646.

[8] *Id.* at 539.

[9] *Treganowan*, CA-2, 50-1 USTC ¶10,770, 183 F2d 288.

[10] *Id.* at 291 (quoting The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance, 59 Yale L. J. 780, 784 (1950)).

[11] *Amerco*, 96 TC 18, 38, Dec. 47,130 (1991), *aff'd*, CA-9, 92-2 USTC ¶50,571, 979 F2d 162 (1992); *The Harper Group*, 96 TC 45, 58, Dec. 47,131 (1991), *aff'd*, CA-9, 92-2 USTC ¶50,572, 979 F2d 1341 (1992); *Sears, Roebuck & Co.*, 96 TC 61, 100-101, Dec. 47,132 (1991), *aff'd*, CA-7, 92-2 USTC ¶50,426, 972 F2d 858 (1992).

[12] *Avrahami*, 149 TC 144, Dec. 60,991 (2017).

[13] *Reserve Mechanical Corp.*, 115 TCM 1475, Dec. 61,196(M), TC Memo. 2018-86, *aff'd*, CA-10, 2022-1 USTC ¶50,159, 34 F4th 881 (2022).

[14] *Syzygy*, 117 TCM 1165, Dec. 61,443(M), TC Memo. 2019-34.

[15] *Caylor Land & Dev't*, 121 TCM 1205, Dec. 61,837(M), TC Memo. 2021-30.

[16] Foreshadowed in a General Counsel Memorandum (GCM 35340 (May 15, 1973)) and formalized in Rev. Rul. 77-316, 1977-2 CB 53.

[17] *Moline Properties, Inc.*, SCt, 43-1 USTC ¶9464, 319 US 436, 63 SCt 1132. The courts accepted taxpayers' argument articulated in *Moline Properties Inc.* that a corporation will be considered a taxable entity separate from its owner so long as it has a valid business purpose.

[18] We note that only one court explicitly adopted the economic family theory. *Stearns-Roger Corp.*, DC-CO, 84-1 USTC ¶9165, 577 FSupp 833, *aff'd on other grounds*, CA-10, 85-2 USTC ¶9712, 774 F2d 414 (1985).

[19] Notwithstanding the IRS theory that a parent cannot shift risk to its captive subsidiary, courts have identified scenarios whereby a parent could enter into a valid insurance arrangement with a captive. For example, in *Sears, Roebuck & Co.*, the Tax Court held that the transfer of some parental risk to the captive may be treated as insurance provided that the captive also insured sufficient other risks. 96 TC 61, Dec. 47,132 (1991), *aff'd in part, rev'd in part*, CA-7, 92-2 USTC ¶50,426, 972 F2d 858 (1992).

[20] *Carnation Co.*, 71 TC 400, Dec. 35,595 (1978), *aff'd*, CA-9, 81-1 USTC ¶9263, 640 F2d 1010 (1981).

[21] *Clougherty Packing Co.*, 84 TC 948, Dec. 42,099 (1985), *aff'd*, CA-9, 87-1 USTC ¶9204, 811 F2d 1297 (1987). *See also Stearns-Roger Corp.*, CA-10, 85-2 USTC ¶9712, 774 F2d 414 (court did not disregard corporate forms, but nevertheless concluded that the risk of loss would effectively remain with the parent since its wholly owned subsidiary would bear the loss, driving down the subsidiary's net worth); *Mobil Oil Corp.*, ClsCt, 85-2 USTC ¶9585, 8 ClsCt 555 (same).

[22] Rev. Rul. 2001-31, 2001-1 CB 1348.

[23] 2002-2 CB 984.

[24] In *Gulf Oil Corp.*, the Tax Court held that two-percent unrelated premiums of the total premiums were insufficient to establish risk shifting and risk distribution. 89 TC 1010, 1028, Dec. 44,341 (1987). In *The Harper Group*, unrelated premiums of 29 percent were held to be sufficient to risk shifting and risk distribution. Moreover, the Tax Court did not say that unrelated premiums below 29 percent were insufficient for risk shifting and risk distribution; merely that 29 percent was sufficient. 96 TC 45, Dec. 47,131 (1991), *aff'd*, CA-9, 92-2 USTC ¶50,572, 979 F2d 1341 (1992).

[25] 2002-2 CB 985.

[26] 2002-2 CB 991.

[27] IRB 2005-27, 4.

[28] *Rent-A-Center, Inc.*, 142 TC 1, Dec. 59,801 (2014).

[29] *Securitas Holdings, Inc.*, 108 TCM 490, Dec. 60,068(M), TC Memo. 2014-225.

[30] We note the opinion does not discuss whether the captive also insured parental risk.

[31] *Securitas Holdings, Inc.*, 108 TCM 490, Dec. 60,068(M), TC Memo. 2014-225.

[32] 2005-2 CB 14.

[33] Notice 2005-49 also requested comments on the factors to be taken into account in determining whether a cell-captive arrangement constitutes insurance as well as federal income tax issues raised by transactions involving finite risk. These discrete points are beyond the scope of this article and are therefore not addressed herein.

[34] 1998 FSA LEXIS 167 (IRS Oct. 19, 1998).

[35] In Rev. Rul. 60-275, 1960-2 CB 43, the IRS concluded that risk distribution did not occur when similar risks were insured in a similar geographic area. In this Revenue Ruling, the taxpayer owned land near a river. The taxpayer and other entities located in the river's flood plain made payments to a collectively owned insurance exchange. In the event of a flood, each affected member would receive payments from insurance exchange, thus minimizing each member's risk of loss in the event of a flood. In the event of a flood, however, it was likely that all members of the exchange would be affected. Based on these facts, the IRS found that risk distribution was not present because each member of the exchange would be exposed to the same risk of loss in the event of a flood. We note that the court in *Weber Paper Co.* dismissed the IRS' analysis in Rev. Rul. 60-275. CA-8, 63-2 USTC ¶9630, 320 F2d 199. The IRS stated in Rev. Rul. 64-72, 1964-1 CB 85 that it would not follow the *Weber* court's decision in similar cases.

[36] *Clougherty Packing Co.*, 84 TC 948, Dec. 42,099 (1985), *aff'd*, CA-9, 87-1 USTC ¶9204, 811 F2d 1297 (1987).

[37] *Securitas Holdings, Inc.*, 108 TCM 490, Dec. 60,068(M), TC Memo. 2014-225.

[38] *Mobil Oil Corp.*, ClsCt, 85-2 USTC ¶9585, 8 ClsCt 555 (1985).

[39] FSA 199945009 (Jul. 29, 1999).

[40] *Id.*

[41] Captive insurance group comments in connection with Notice 2005-49 from Vermont Captive Insurance Association (the "VCIA"). The comment letter is available at *Captive Insurance Group Comments on Guidance on Single Insurer Arrangements*, 2005 TNT 203-32.

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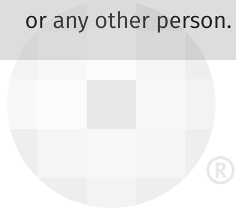

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