DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (LMSB) NATURAL RESOURCES

FROM:

LON B. SMITH
Acting Associate Chief Counsel (Financial Institutions and Products) CC:FIP

SUBJECT:

TL-N-5650-00

This memorandum constitutes Chief Counsel Advice. In accordance with § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Operating Subsidiary 1 =

Operating Subsidiary 2 =

U.S. Holding =

Parent =

Grandparent =

Country Q =

Country R =

State A =

State B =

Insurance Subsidiary =

Intermediate Holding =

Foreign Holding =

Investment Subsidiary =

work =

works =

working =

a =

b =

c =

Date A =

Year 1 =

Year 2 =

Year 3 =

r =

t =

u =

m =

n =

v = _____

w =

y = _

x =

Unrelated Insurer = ___

ISSUES

(1) Whether the economic family theory set forth in Rev. Rev. 77-316, 1977-2 C.B. 53, applies to prevent the taxpayer from deducting purported insurance premiums paid to a related insurance company?

(2) Whether the facts in this case are sufficiently different to distinguish the case from the taxpayer in Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989)?

CONCLUSIONS

(1) After your request was submitted to this office, Rev. Rul. 77-316 was obsoleted by Rev. Rul. 2001-31, 2001-26 I.R.B. 1348 (June 25, 2001). In view of this development, you should not assert the economic family theory as a basis for disallowing the deductions at issue.

(2) We believe additional development is warranted before you conclude the deductions in this case should be allowed under Humana, Inc. v. Commissioner.

FACTS

During the years under consideration, Grandparent was the overall parent of all of the related the companies discussed below. The underlying issue in this case is whether the contracts between Insurance Subsidiary and other members of Grandparent's group of affiliated companies are insurance contracts for federal income tax purposes. The years at issue are Years 1 and 2. (The incoming submission includes facts concerning Year 3. To the extent those facts differ from the facts in Years 1 and 2, we do not think the facts are sufficiently developed to warrant separate discussion in this memorandum. See Case Development, Hazards, and Other Considerations.)

Background: Ownership and Capitalization

At the beginning of Year 1, U.S. Holding was a wholly owned domestic subsidiary of Parent. U.S. Holding, in turn, owned all of the stock of Operating Subsidiary 1. Operating Subsidiary 1 is a State A corporation which owns and operates two r works called the a and b works on a single piece of property in State A, the two works share a joint processing facility. Operating Subsidiary 2 is a State B corporation which owns and operates one r work called c on a piece of property in State B. All of the stock of Operating Subsidiary 2 was owned by Parent.

Insurance Subsidiary is a Country R corporation which was incorporated on Date A for the stated primary purposes of providing environmental liability coverage to Grandparent's owned indirectly United States operating subsidiaries. Grandparent

owned all of the stock of Insurance Subsidiary. Insurance Subsidiary's initial capitalization consisted of approximately $20x.

Grandparent, the overall parent of the affiliated group, owned all of the stock of Parent. U.S. Holding owned all of the stock of Operating Subsidiary 1. Parent owned all of the stock of Operating Subsidiary 2. At the beginning of Year 1, shareholder's equity in Insurance Subsidiary was almost $36x. The officers and directors of Insurance Subsidiary, with the exception of corporate counsel, were also officers and directors of U.S. Holding and Grandparent.

During Year 2, Grandparent continued to own 100% of Parent and Parent continued to own 100% of Operating Subsidiary 2. The stock of U.S. Holding continued to be owned by Parent. U.S. Holding owned all of the stock of Intermediate Holding, a domestic corporation, which, in turn, owned all of stock of Operating Subsidiary 1. Grandparent transferred its ownership of Insurance Subsidiary to Foreign Holding at the beginning of Year 2. Foreign Holding is approximately 70% owned by Grandparent and approximately 30% owned by Investment Subsidiary, which was 100% owned by U.S. Holding.

The Transactions at Issue

During Year 1 and Year 2 Insurance Subsidiary provided three types of policies to the Grandparent's U.S. subsidiaries, Operating Subsidiary 1 and Operating Subsidiary 2 (not all of the policies were offered in each full year). These policies are: (1) environmental impairment liability insurance, (2) excess liability on property, boiler and machinery coverage, and (3) buy-back deductible. In addition, the taxpayers took action in Year 3 to retroactively provide Contractor's blanket wrap-up liability coverage for Year 2, which will be discussed below.

Under the environmental liability policy Insurance Subsidiary indemnifies the insured against all damages (including defense costs) that the insured shall be legally obligated to pay arising out of claims for environmental impairment in connection with the location(s) and business of the insured for which there is (a) a claim first made against the insured or other notice of claim first received by the insured during the policy period and within the territorial limits. Environmental impairment means any and all: (a) bodily injury, (b) property damage, (c) interference with or diminution of any environmental right or amenity protected by law, and (d) liability for clean up inside and outside the premises of the insured; arising out of any and all emissions, discharges, dispersals, disposals, seepages, releases or escapes of any liquids, solids, gaseous or thermal irritants into or upon land, the atmosphere or any water course or body of water or generations of smells, noises, vibrations, light, electricity, radiations, changes in temperature or any other sensory phenomena. While there is no deductible on this policy, there is a limit of liability for any one claim of $20x and also an aggregate limit of $20x for each policy period. The aggregate amount payable for loss under this policy

for each policy period shall be reduced by amounts paid or payable under any other environmental impairment liability policy issued by Insurance Subsidiary during the same policy period. While the policies themselves do not indicate what law governs their interpretation, section t of the Insurance Act (u) of Country R provides, in part, that policies issued in Country R are subject to its laws and judicial system. No claims on the environmental liability policies have ever been paid or incurred.

The excess limits policy is insurance on working and related operations above the primary amount of insurance provided by another carrier. There is no deductible on this coverage. There is a limit of $20x per occurrence and in the aggregate for each policy period. The aggregate annual limit of $20x is, in effect, shared by both Operating Subsidiary 1 and Operating Subsidiary 2 because the excess limits policy (e.g., policy number m) was issued to the two operating subsidiaries jointly. As with the environmental policy discussed above the excess limits policy did not state what law governed its interpretation. However, Country R's Insurance Act provides that Country R law applies to policies issued in Country R. There have been no claims on the excess limits policies.

The deductible buy-back coverage results in the elimination of the deductible on the coverage of another carrier and this is accomplished in this case by the payment of a premium to Insurance Subsidiary. This has the effect of first dollar coverage with regard to the covered risk. Through the end of Year 2, Insurance Subsidiary paid 15 claims on the deductible buy-back policies totaling approximately $1.5x.

Contractor's blanket wrap-up liabilities are designed to insure the type of liabilities listed in the "exclusion" section of a contractor's wrap-up liability policy.[1]

With respect to the policies covering Year 1, Insurance Subsidiary issued an environmental liability policy (policy number v) to Operating Subsidiary 1 for an annual

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[1] When the operating subsidiaries begin a substantial project at a work site many contractors are involved. The contractors have individual general liability policies and the Operating Subsidiaries take out a contractors wrap-up liability policy (Wrap-up Policy). This contractor's wrap-up liability policy differs from the contractor's blanket wrap-up liability policy issued by Insurance Subsidiary (the Blanket Policy). The Wrap-up Policy is a general liability policy designed to insure a particular project and particular named insureds. It provides the primary coverage for any claims that may arise during the course of a particular project and is used to isolate these claims under one general liability policy. In contrast, the Blanket Policy is designed to insure the type of liabilities listed in the "exclusion" section of the Wrap-up policy for the type of events covered under the Blanket policy. The named insureds, the contractors, were not informed that they were insureds.

premium of approximately $1.5x and a separate environmental liability policy (policy number w) to Operating Subsidiary 2 for an annual premium of $.275x. Also in Year 1, there was an excess limits policy (policy number m) with Insurance Subsidiary jointly covering both Operating Subsidiary 1 and Operating Subsidiary 2. Finally, during the year, there was a deductible buyback policy (policy number n) jointly issued to Operating Subsidiary 1 and Operating Subsidiary 2. All three types of policies provided by Insurance Subsidiary for Year 1 functioned similarly in that the aggregate limit on the policy(s) was shared by Operating Subsidiary 1 and 2. For example, if Operating Subsidiary 2 had a covered loss of $20x under its environmental policy in January of Year 1, the aggregate limit for all environmental policies issued by Insurance Subsidiary would be reached and it appears that Operating Subsidiary 1 would be unable to collect any amount under its environmental liability policy in Year 1. The other two types of policies, excess limits and deductible buyback, are joint policies and appear to operate in the same fashion. For example, if Operating Subsidiary 1 were to submit to Insurance Subsidiary valid claims of $20x on the excess limits policy and $2x on the deductible buy-back policies in February of Year 1, it would appear that Operating Subsidiary 2 would be unable to collect any amounts on either of these two policies for Year 1 because the aggregate limits are $20x and $2x, respectively.

During Year 2, Insurance Subsidiary issued an environmental liability policy to Operating Subsidiary 1 for an annual premium of approximately $1.5x and a separate environmental policy to Operating Subsidiary 2 for an annual premium of $.275x. Also during the year Insurance Subsidiary issued a joint excess limits policy to both Operating Subsidiary 1 and 2. Finally, Insurance Subsidiary issued a deductible buyback policy jointly to Operating Subsidiary 1 and 2.

During Year 2, Unrelated Insurer indicated its willingness to issue an environmental policy to Operating Subsidiaries 1 and 2 for a premium of $.4x. However, the policy proposed by Unrelated Insurer would cover environmental damage only beyond the confines of the respective working properties owned by Operating Subsidiaries 1 and 2. (In contrast, Insurance Subsidiary's policy covered environmental liability for "clean up inside and outside the premises of the insured.") After the end of Year 2, the environmental liability premiums charged by Insurance Subsidiary were retroactively reduced to bring these premiums within $.1x of the cost of the premiums that Unrelated Insurer offered when it began offering environmental coverage in Year 2. This was accomplished by cancelling each of the (two) environmental policies that Insurance Subsidiary separately issued to Operating Subsidiary 1 and 2, and returning the premium to them. Insurance Subsidiary then issued a joint policy to six related insureds, including Operating Subsidiary 1 and 2 retroactively for premiums of approximately $.6x. Thus, Insurance Subsidiary retroactively reduced the environmental liability coverage charges that Operating Subsidiary 1 and Operating Subsidiary 2 had to pay and added coverage to four additional related insureds at the end of Year 2 and the beginning of Year 3. Also at this time, for Year 2 Insurance Subsidiary added contractor's blanket wrap-up liability

policies listing seven independent contractors as the named insureds. Taxpayer states it was unnecessary for Insurance Subsidiary to inform the contractors that they were the named insureds (or even of the existence of the policies) because the objective was to protect Operating Companies 1 and 2. The increase in total premiums stated to have been charged by Insurance Subsidiary for the buy-back deductible, excess limits and a new wrap-up liability insurance premium was approximately equal to the reduction in the environmental premiums charged to Operating Subsidiaries 1 and 2.

As indicated above, until sometime in Year 2, no unrelated insurance carrier provided environmental liability to working operations in the United States. However, Unrelated Insurer offered somewhat similar policies overseas to foreign companies. Earlier (prior to Year 2) Insurance Subsidiary contacted Unrelated Insurer for estimates as to the range for premiums charged.[2] There is no information in the file indicating that in pricing the policies that Insurance Subsidiary secured the services of an actuary to evaluate its own exposure to environmental liability.

No fronting companies or reinsurers were involved, and there were no indemnification agreements, comfort letters, or other means by which the purported insureds or some other party guarantees the performance of Insurance Subsidiary

As of the end of Year 2, the principal assets listed on Insurance Subsidiary's balance sheet were deposits with an affiliate of approximately $45.3x; its total gross assets at that time were $46.4x. Thus, as of the year-end of Year 2, the percentage of Insurance Subsidiary's gross assets invested with an affiliate was approximately 97.5%.

For Year 1 Operating Subsidiary 1 paid in excess of 86% of the premiums collected by Insurance Subsidiary and for Year 2 it paid over 88% of the premiums collected by Insurance Subsidiary. In addition, the bulk of the premiums received by Insurance Subsidiary were paid late.

LAW AND ANALYSIS

Section 162(a) of the Internal Revenue Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred in the taxable year in carrying on any trade or business.

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[2] As environmental laws of different countries vary significantly, it may be difficult to draw accurate comparisons as to the operating effect of one policy as opposed to another.

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, storm, 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 accepted definition of "insurance" for federal income tax purposes relates back to Helvering v. LeGierse, 312 U.S. 531, 539 (1941), in which the Supreme Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." Risk shifting occurs where a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer. If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance payment. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution has been explained as incorporating 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 premium and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. See Clougherty Packing Co. at 1300.

In determining the propriety of claimed insurance deductions by a parent or affiliated company to a captive insurance company, in Harper Group & Subsidiaries v. Commissioner, 96 T.C. 45, 58 (1991), aff'd. 979 F.2d 1341 (9th Cir. 1992) the U.S. Tax Court set forth the following 3-prong test that must be applied, and each part must be satisfied: (1) whether the arrangement involves the existence of an "insurance risk";(2) whether there was both risk shifting and risk distribution; and (3) whether the arrangement was for "insurance" in its commonly accepted sense.

Thus, both risk distribution and risk shifting are basic requirements for insurance for federal income tax purposes. In addition, recent court decisions articulate a requirement that a transaction be "insurance" in its commonly accepted sense. AMERCO Inc. v. Commissioner, 96 T.C. 18, 42 (1991) aff'd. 979 F.2d 162 (9th Cir. 1992); Harper Group & Subsidiaries, supra; Sears, Roebuck and Co. v. Commissioner, 96 T.C. 61, 101-102 (1991), aff'd in part, rev'd in part, 972 F.2d 858 (7th Cir. 1992); Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42, 51-53 (1997). Commentators on insurance theory also accept the idea that risk distribution is a requirement for insurance. For example, a widely adopted definition of "insurance" is provided by Allan Willett:

> ... that social device for making accumulations to meet uncertain losses of capital which is carried out through the transfer of risks of many individuals to one person or to a group of persons. Wherever there is accumulation for uncertain losses, or wherever there is a transfer of risk, there is one element of insurance; only where these are joined with the

> combination of risks in a group is the insurance complete. (Underlining supplied.)[3]

Early case law established the principle that reserves for losses held in segregated funds or revocable trusts are a form of self-insurance and are not deductible as insurance reserves. While funds established by an operating business company may be similar in purpose to the reserves of insurance companies, the reserves of insurance companies are deductible under Code sections that do not apply to non-insurance companies. Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930). Considerable case law addresses the use of related corporations to achieve a result parallel to that of the situation in Spring Canyon Coal Co. In general, where a parent attempts to purchase insurance from its wholly-owned captive insurance subsidiary there is not sufficient risk shifting to constitute insurance for federal income tax purposes where the subsidiary insures only its parent or its parent's other non-insurance subsidiaries, e.g., Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir 1981), cert. denied, 454 U.S. 965 (1981); Clougherty, supra. In contrast, both the United States Court of Appeals for the Sixth Circuit and the United States Court of Federal Claims held that under the facts presented, payments to a captive insurer by its sibling subsidiaries were deductible as insurance premiums. Humana, Inc. v. Commissioner, supra; Kidde Industries, Inc., supra.

In Malone and Hyde, Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995), the Sixth Circuit applied Humana to a brother-sister insurance transaction and concluded that the captive insurer was a sham, and the payments at issue were therefore not deductible under § 1.162-1(a) of the regulations as insurance premiums. In Malone, the taxpayer and the operating subsidiaries purchased insurance from a commercial insurer, which then reinsured a significant portion of the premiums received from the taxpayer, and paid the remainder to the captive as a reinsurance premium. The taxpayer claimed deductions for the insurance premiums paid to the commercial insurer. In determining that the company was a sham, the court in Malone noted that the parent "propped-up" the captive by guaranteeing its performance, the captive was thinly capitalized, and the captive was loosely regulated by the locale in which it was incorporated (Bermuda). Id. at 840.

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[3] Allan H. Willett, The Economic Theory of Risk and Insurance 72 University of Pennsylvania Press, Philadelphia (1951). See also Robert Riegel, Insurance Principles and Practices, 27-28 Prentice-Hall, Inc., Engelwood Cliffs (5th ed. 1966) (Insurance may be defined as a combination of individuals who agree to make small contributions in order to reimburse those who suffer losses that may be foreseen and estimated. A combination of risks is necessary ... in that it must be possible to estimate the probable loss.) William R. Vance, Handbook on the Law of Insurance, 1-2 West Publishing Co., St. Paul (1951).

Other factors to consider in determining whether a transaction will be treated as insurance for federal income tax purposes include whether a captive insurance transaction is a sham, and whether the captives' business was kept separate from its parent's. Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728-729 (1991), aff'd. 988 F.2d 1135 (Fed. Cir. 1993).

In Rev. Rul. 77-316, three situations were presented in which a taxpayer attempted to seek insurance coverage for itself and its operating subsidiaries through taxpayer's wholly-owned insurance subsidiary. The ruling explained that taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented "one economic family" for purposes of analyzing whether transactions involved sufficient risk shifting and risk distribution to constitute insurance for federal income tax purposes. The ruling concluded the transactions were not insurance to the extent that risk was retained within the economic family. Therefore the premiums paid by the taxpayer and its non-insurance subsidiaries to the captive insurer were not deductible.

In Rev. Rul. 2001-31, the Service explained that it would no longer invoke the economic family theory with respect to captive insurance transactions. Accordingly, the economic family should not be asserted in this case as a basis for disallowing deductions for putative insurance premiums paid to Insurance Subsidiary.

Although the present case lacks some of the abusive factors which were present, for example, in Malone and Hyde, Inc. v. Commissioner, we believe that the facts as presented to us suggest other grounds for denying deductions for purported insurance premiums in the present case.

First, it appears likely the transactions at issue lack sufficient risk distribution to constitute insurance, because one insured accounted for 86 to 88% of Insurance Subsidiary's premium income, and because Operating Subsidiary 1's a and b working operation accounted for the vast majority of the risks covered. As noted above, the concept of "insurance" requires both risk shifting and risk distribution. In Rev. Rul. 60-275, 1960-2 C.B. 43, members of a reciprocal insurance exchange were limited to specific groups within the same flood district, each facing similar hazards. The ruling concludes there was little likelihood that there could be a real sharing of risk because they were in the same flood basin.[4] Similarly in the present case, we expect that with only the working operations of Operating Subsidiary 1 and 2, Insurance Subsidiary was unable to achieve adequate risk distribution which, as discussed previously,

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[4] See also Rev. Rul. 64-72, 1964-1 C.B. 85, the Service will not follow the decision of the U.S. Court of Appeals for the Eighth Circuit in United States v. Weber Paper Co., 320 F.2d 199 (8th Cir. 1963), aff'g. 204 F. Supp. 394 (1962).

incorporates the concept of the law of large numbers.[5] The inherent risk distribution in the present case is much more limited than the three brother-sister captive insurance cases that the Government has lost. In Humana, supra, (88 T.C. at 199) during the years under consideration the taxpayer operated an average of 77 hospitals with 12,558 patient beds for which it needed liability coverage. In HCA v. Commissioner, T.C. Memo 1997-482 (1997), the taxpayer operated an average of 160 hospitals with an average of 26,574 patient beds for which it needed similar coverage. In Kidde Industries, Inc., supra, the taxpayer was a broad based decentralized conglomerate with 15 separate operating divisions and 100 wholly owned operating subsidiaries for which it needed workers' compensation, automobile and general (including products) liability coverage.[6] In contrast, the present case involves risks of two insureds and two working operations (one of which consists of the a and b works with a joint processing faculty on the same property).

Another requirement for insurance is risk shifting. In the present case risk shifting is diluted as to one operating subsidiary to the extent that another operating subsidiary has claims. This is illustrated by the environmental liability policies issued for Year 1 where the aggregate limit is diluted depending upon whether Insurance Subsidiary sells additional policies that subsequently have claims on them. It is also

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[5] For purposes of these comments on risk distribution we are assuming that for Year 1 and 2 only the two working operations of Operating Subsidiary 1 and 2 were involved and that, for Federal tax purposes, no other operating subsidiaries were in the position of insureds. Without question, Operating Subsidiary 1 and 2 are the only parties intended to be covered in Year 1. Year 2 is somewhat more complicated because of the purported cancellation of the original Year 2 policies and their retroactive replacement of new policies with new insured parties that occurred (in Year 3) with respect to Year 2. You should consider whether the cancellation and retroactive replacement of the policies with respect to Year 2 should be ignored for Federal tax purposes. Courts have not looked with favor upon retroactive revisions of written instruments, or even State court decrees, as a ground for determining tax liabilities. See e.g., Van Den Wymelenberg v. United States, 397 F.2d 443, 445 (7th Cir. 1968) (as to parties to the reformed instrument the reformation relates back to the date of the original instrument, but does not effect the rights of non-parties, including the Government). Finally, the annual accounting period requirement supports the idea that generally a taxpayer cannot effect by actions in a later year (Year 3) the tax treatment of items in an earlier year (Year 2). See section 441(c).

[6] By contrast, in some cases the Government has successfully denied deductions to operating subsidiaries for amounts paid as insurance premiums to a captive insurance subsidiary. See e.g., Malone and Hyde,Inc, supra, and two Ninth Circuit decisions, Carnation Co., supra, and Clougherty Packing Co., supra.

illustrated by the jointly issued excess liability and the deductible buy-back policies. One could argue that the policy is not an insurance contract because the limit on the amount payable to the insured when a loss event occurs is unknown.[7] To the extent that the policy in the present case does not provide the insured a fixed amount when the loss event occurs, it arguably should not be viewed as being insurance.

We doubt that unrelated parties would have entered into these contracts at arms-length. Further development of this issue may suggest the transactions lack economic substance, or that they do not constitute insurance in the commonly accepted sense. The retroactive changes to the contracts at issue for Year 2 are troubling and likely would not pass muster in an arms-length context. (In fact, we suspect the reason for cancelling the existing polices with respect to Year 2 and retroactively providing a new policy that included additional insureds was primarily to "reallocate" the premiums and thus make the pricing for the environmental policy appear comparable to that offered by Unrelated Insurer.) Another factor that would undercut the policy's viability on the commercial market is that 97.5% of Insurance Subsidiary's assets, as of year-end Year 2 are held by an affiliate of the Insurance Subsidiary. The commercial market generally does not permit the insurer to place substantially all of its investments with affiliates. Further, in terms of the concern expressed in Ocean Drilling, supra, at 728-729 this type of joint policy activity is really not keeping the captive's business separate from its affiliates.

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[7] The Sixth Circuit in Humana v. Commissioner, supra, set forth an excerpt from the report of two experts, Irving Plotkin and Richard Stewart. The excerpt indicated that commercial insurance is a mechanism for transferring the financial uncertainty arising from pure risks faced by one firm to another in exchange for an insurance premium. Further, these experts pointed out that the essential element of an insurance transaction from the point of view of the insured (e.g., Humana and its hospital network), is that no matter what insured perils occur, the financial consequences are known in advance. (Emphasis supplied.) Expressed another way, once an insured pays a premium, in the true insurance situation, the insured is neutral as to whether the loss event occurs. Focusing on the balance sheets of the brother-sister operating subsidiaries in Humana, the Sixth Circuit concluded that those operating subsidiaries had achieved that neutrality because loss events covered by the captive insurance subsidiary did not directly impact their balance sheets. The parent's balance sheet, however, was directly affected by the captive insurance subsidiary's losses and was not considered to have any insurance relationship with the captive for federal tax purposes. Similarly, much like the parent in Humana because of contract provisions in the present case, one operating subsidiary is not neutral as to the events involving other operating subsidiaries and Insurance Subsidiary, hence, the relationship between the operating subsidiaries and Insurance Subsidiary is not one of insurance for federal income tax purposes here.

There is also an excessive degree of informality between the parties. The bulk of the premiums are paid late. Again, by way of example, cancellation of the environmental liability (claims made) policies for Year 2 after the end of Year 2 and substituting (four additional) related insureds in a new (claims made) policy for Year 2 appears to depart from normal arms-length behavior.[8] The purchase of the insurance naming the contractors as the insureds but not informing them may merit further inquiry, specifically as to whether the contractors really were intended to be insured.

Finally, Insurance Subsidiary was never used to allow the Operating Subsidiary 1 and 2 to gain entrance to the reinsurance market and does not seem to have a sufficient non-tax business purpose to justify the expenses of keeping it going.[9] Loaning out substantially all of its assets to an affiliate, Insurance Subsidiary resembles an incorporated pocket-book, representing a reserve for self-insurance much like the one described in Spring Canyon, supra.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

With respect to the argument that insurance does not exist because of a failure of risk distribution, the Government would have to contend with the Government's Eighth Circuit loss in Weber Paper, supra, which involved taxpayers in the same flood plain. We note that it does not appear that the theoretical aspects of risk distribution were presented to the court in any depth and the court went out of its way to emphasize that the people promoting "this flood insurance plan were acting in entire good faith." In any event, we understand from the International Examiner that the taxpayers' venue is to the Ninth Circuit and not the Eighth.

[redacted]

[8] The billing and payment of this arrangement relating to the Year 2 (claims made policies) did not occur until well into Year 3.

[9] An additional expense if any litigation arose is the cost of resolving that in the courts of Country R, rather than in the United States. Further, for companies located in the United States (Operating Subsidiary 1 and 2) this prospect of dealing with foreign law undercuts the notion that the policy is on a par with a policy that might otherwise be commercially available.

[redacted][10]

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

Acting Associate Chief Counsel
(Financial Institutions & Products)
By: MARK SMITH
Chief, CC:FIP:4

[10] [redacted]