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Seeking Out Safe Harbours

Legal firm LeBoeuf, Lamb, Greene & MacRae L.L.P. deliver guidance on how the latest IRS Revenue Rulings and Revenue Procedure will affect captive insurance companies

P. Bruce Wright, John W. Weber and Arthur J. Lynch

0n 11 December 2002 the US Internal Revenue Service (IRS) issued three revenue rulings. (Rev. Ruls. 2002-89, 2002-90 and 2002-91) and a new revenue procedure (Rev. Proc. 2002-75). These follow more than a year after Rev. Rul. 2001-31 declared obsolete both Rev. Rul. 77-316, 1977-2 CB 52, which, in general, sought to deny deductions for premiums between affiliated entities (both parent entities and operating affiliates) and captives, and Rev. Rul. 88-72 which, in general, sought to disregard the presence of unrelated business in determining whether premium paid for related risk was deductible. Set forth below is a brief discussion of these new precedents.

Rev. Rul. 2002-89

Rev. Rul. 2002-89 considers two situations. In the first, P, a domestic entity, enters into an insurance contract with its subsidiary, S, to insure the professional liability risks of P (either directly or as a reinsurer). S is regulated as an insurer in each state in which it does business. The premiums paid by P to S under the insurance/reinsurance contracts are established according to customary industry rating formulas, and P and S conduct themselves consistently with the standards applicable to an arm's-length insurance arrangement. S writes similar contracts for unrelated parties, and the premiums paid by unrelated parties also are based on customary industry rating formulas. P does not provide any guarantee of S' performance and all funds and business records of P and S are separately maintained. S does not loan any funds to P. The premiums S earns from the contracts with P constitute 90 per cent of S' earned premium on a net and gross basis, and the coverage provided to P accounts for 90 per cent of the total risks borne by S.

P. Bruce Wright chairs the tax department at LeBoeuf, Lamb, Greene & MacRae, L.L.P., where he concentrates in tax and insurance law issues including representation of property and casualty insurance companies, formation of single parent/group captive insurers, counseling of risk retention groups and creation of various types of alternative risk financing mechanisms, including, among others, rent-a-captives and cell companies.

John W. Weber focuses his practice on federal and state taxation, providing clients with advice regarding foreign tax topics and issues related to insurance companies and insurance products. In this regard, he provides advice regarding insurance tax accounting issues and issues regarding the formation and operation of domestic and offshore insurers. He also provides advice regarding tax-exempt bond issuers, mergers and acquisitions, consolidated return problems, tax issues related to insolvencies and state franchise, sales, property and other tax issues.

Arthur Lynch concentrates in tax law, including matters relating to public and private offering of securities of offshore insurance companies, domestic and cross-border reorganizations, the formation of captive insurers, the structuring of alternative risk financing arrangements, the structuring of international insurance and reinsurance of global investors, the use of capital market and hedge fund strategies by insurers and other issues related to the convergence of the insurance and capital markets.

In the second situation, the facts are the same except that P's premiums constitute less than 50 per cent of the net and gross earned premiums. The liability coverage S provides to P accounts for less than 50 per cent of the total risks borne by S. Although the premiums are found not to be deductible in the first (90 per cent) fact pattern, the IRS held that they were deductible in the second.

Rev. Rul. 2002-89 seems to provide a safe harbour. The 50 per cent rule that can be inferred from the ruling is based on a number of field service advices that the IRS has published during the last few years and the IRS' reference in Rev. Rul. 2001-31 to reviewing 'other factors' in determining whether premium paid to a captive insurer is deductible as premium in the year in which it is paid.

Set forth below is a brief analysis of these so-called `other factors'. With regard to some of them, there are arguments that may well counter the IRS positions. These are, however, beyond the scope of this article.

1. Guarantees

In a number of cases, the courts have denied a deduction for premiums paid if a parental guaranty, hold harmless agreement or similar arrangement was in place with respect to the obligations of the insurance subsidiary. See, e.g., Malone & Hyde Inc v Commissioner, 62 F.3rd 835 (6th Cir. 1995), rev'g 66 TCM 1551, and Kidde Industries Inc v United States, 40 Fed Cl. 42 (1997). Accordingly, Rev. Rul. 2002-89 posits that such arrangements are not in place.

2. Loanbacks

Rev. Rul. 2002-89 posits no loanbacks to P. In several field service advices (see, e.g., FSA 200202002), the IRS has taken the position that loans from the insurance subsidiary to the parent or other affiliates may affect deductibility (although the IRS has indicated that a loan of a significant portion of premiums by a captive to a finance affiliate that is not insured by the captive may not adversely affect the premium deductibility analysis in FSA 199945009).

3. Unrelated premium tested on both a net and gross earned basis

There have been four cases which have specifically held that the introduction of unrelated business in sufficient amounts results in a deduction for related business that might otherwise not be deductible, see The Harper Group v Commissioner, 96 T.C. 45, aff'd 979 F.2d 1341 (9th Cir. 1992); Ocean Drilling & Exploration Co v United States, 988 F.2d 1135 (Fed. Cir. 1993); AMERCO, Inc v Commissioner, 97 F.2d 162 (9th Cir. 1992); Sears Roebuck and Co. v. Commissioner, 96 T.C. 61, aff'd in part, rev'd in part 972 F.2d 858 (7th Cir. 1992). The cases, however, all dealt with a comparison of related and unrelated premium on a gross basis, i.e., no reinsurance of either the net or gross premium was discussed. Clearly, the IRS is taking the position that ratios of unrelated business to total business must be tested on both a net and gross basis. Thus, for example, if an insurance subsidiary were to write US$100x of related premium and US$100x of unrelated premium and retrocede or reinsure the US$100x of unrelated premium to an unrelated party, the IRS would conclude that since no net unrelated premiums were retained there could be no deduction for related business based on the gross amount of unrelated business assumed.

In addition, the IRS seems to be making clear that they will be applying the test on an earned basis, accordingly, e.g., writing substantial amounts of unrelated premium on the last day of the year would not normally result in a deduction for related premium as little of the unrelated premium would be earned at year-end.

When these factors are combined with the requirement of homogeneity of risk discussed immediately below, it seems clear that the IRS has attempted to tighten the mechanics for measuring unrelated risk.

4. Homogeneity of risk

The IRS has in at least one field service advice (FSA 1998-578) indicated that unrelated business must be of the same kind (here all is professional liability). Hence, Rev. Rul. 2002-89 posits that all of the risks are of one kind.

5. Liability analysis

This seems to be a new 'other factor' (it is not discussed in recent field service advices), i.e., that the liability risks borne by S comport with the premium analysis. Thus, the IRS might argue if an amount of premium for related risk is equal to unrelated premium, but the related risk assumed is an excess cover giving rise to a greater exposure of limits, it could question the deduction for the premium paid.

6. Quantum of unrelated risk

Rev. Rul. 2002-89 also looks to amount of unrelated risk. In general, a number of cases have indicated that premium ceded from a parent to an insurance subsidiary was not deductible but premium paid by an operating subsidiary to an insurance subsidiary was deductible, see, e.g., in general, Humana, Inc v Commissioner, 881 F.2d 247, 257 (6th Cir. 1989), Kidde, supra, Hospital Corporation of America v Commissioner, 74 TCM 1020 (1997). However, the Harper case, supra, held that if approximately 30 per cent of premium was unrelated, a deduction would be afforded to the related party for premium that could not qualify under the Humana line of cases, e.g., that paid by its parent. Comparing Situation 1 at 10 per cent in which no deduction is allowed and 50 per cent in Situation 2 in which a deduction is allowed, the IRS is establishing another safe harbour and, perhaps indicating a grey area as far as it is concerned (notwithstanding Harper) below the 50 per cent level of unrelated premium.

7. Arm's-length premium according to customary industry formulas and normal insurance practices

Clearly the IRS is indicating that premiums cannot be arbitrary, and it may be inferred that the IRS expects an actuarial determination to be used to set premiums. In FSA 200202002, the IRS National Office indicates that loose attention to the structures of an insured/insurer relationship would not be a helpful factor in determining premium deductibility. In this ruling, the IRS indicates that both related and unrelated premium are based on customary industry formulas, and that P and S conduct themselves in a manner similar to standards applicable to an insurance arrangement between unrelated parties (e.g., separation of funds and business records of P and S, and no loan-back from S to P).

Rev. Rul. 2002-90

Rul. 2002-90 establishes further safe harbours. It involves a domestic holding company with 12 operating subsidiaries, which have a `significant volume of independent homogeneous risks.' P, the parent, also owns S, a domestic insurer formed for a valid non-tax business purpose and licensed in each of the states in which its 12 operating subsidiaries have operations. S is adequately capitalised. Each operating subsidiary is charged an arm's-length premium according to customary industry formulas. None of the operating subsidiaries have liability coverage for less than 5 per cent nor more than 15 per cent of the total risk insured by S.

There are no guarantees of S' obligations by P or any related person, and no loans by S to P or to any of the 12 subsidiaries. No other insurance is written. The risks written are professional liability. The ruling concludes the arrangements between S and its affiliates is insurance for federal income tax purposes.

1. Number of insureds

The IRS has in one recent field service advice (FSA 200202002) indicated that the Humana, supra, line of cases applies only where there are multiple affiliated subsidiaries involved. Clearly, that position is adopted in Rev. Rul. 2002-90 establishing a safe harbour at 12.

2. Business purpose

Although not specified, the IRS noted that S was formed for a valid non-tax business purpose.

3. Adequate capitalisation

The IRS indicated that P provided S with adequate capital, addressing a factor in Malone & Hyde, supra, that formed part of the basis for denying the deduction.

4. Arm's-length premiums according to customary industry formulas and normal insurance practices

The IRS also noted that the parties conducted themselves in a manner consistent with standards applicable to an insurance arrangement between unrelated parties (for example, arm's-length premiums, and no parental guarantees or loan-backs to P or 12 operating subsidiaries).

5. Concentration of risk

Rev. Rul. 2002-90 seems to take the position that no subsidiary should account for more than 15 per cent of the total risk insured (perhaps this means that arguments are available that the number of insureds under the safe harbour could be seven not 12).

Rev. Rul. 2002-91

Rul. 2002-91 deals with a group captive arrangement. The only published prior guidance in this area was set forth in Rev. Rul. 78-338, 1978-2 C. B. 107, which dealt with a group of 31 unrelated participants. Rev. Rul. 2002-91 deals with a significantly smaller group of unrelated businesses in one concentrated industry that face significant liability hazards. Insurance is required by regulators and affordable insurance is not available from commercial insurers. D, the taxpayer, and a group of industry members form a group captive, GC, which only writes the risks of X and the other industry members. No member of GC owns more than 15 per cent of GC and no member has more than 15 per cent of the vote of GC on any corporate governance issue. Further, no member's individual risk that is insured with GC exceeds 15 per cent of the total risk insured by GC.

GC uses actuarial techniques based on, in part, commercial rates for similar risks to determine premiums to be charged. GC pools all premiums, investigates claims to determine the validity of claims. No member has an obligation to pay additional premium if its premium is insufficient to pay its losses for any period, or gets a refund if its premiums exceed losses. Premiums may be used to settle claims of other members. If a member terminates coverage or sells its interest in GC, it is not required to make additional premium payments or capital payments to cover losses that exceed the premiums it has paid, nor can a member in such circumstances receive a refund of premium if premium exceeded losses.

The conclusion is that premiums are deductible and that GC is in the business of issuing insurance policies. Again, the IRS is providing a safe harbour with more substance than Rev. Rul. 78-338, which did not address the provisions of the policy.

1. Business purpose

The IRS makes clear that they are looking for an independent business, as distinguished from a tax purpose, in forming the captive, by reference to the lack of affordable coverage for the industry that formed the captive.

2. Adequate capitalisation

One factor referred to in Malone & Hyde, supra, in denying the deduction to the operating entities involved was a lack of adequate capitalisation of the captive involved.

Here, the IRS indicates capital is adequate.

a. Size of the group

The IRS seems to be reducing the safe harbour 'size' of the group from the 31 in Rev. Rul. 78-338, to seven approximately equal shareholders/insureds.

b. Arm's-length premiums using recognised actuarial techniques and normal insurance practices

The IRS again indicates that premiums cannot be arbitrary, noting that GC uses recognised actuarial techniques based, in part, on commercial rates for similar coverage.

The IRS again posits normal insurance practices as a standard, such as investigation of claims before payment and the separation of GC's assets and business operations from those of its owners.

c. Policy provisions

The IRS apparently has become concerned with group captive policy provisions that could have the effect of reducing or eliminating risk transfer through:

(a) payment of additional premium by a member to cover its own losses, and refunding excess premiums paid by a member so that each member covers its own losses and pooling is decreased or eliminated;

(b) payment by an insured of additional amounts on termination of the insurance relationship with the group captive to cover the insured's losses or a refund to the insured of the excess of premiums paid over insured loss. In addition, the IRS seems to be dealing with cases such as Commissioner v Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971), and Black Hills Corporation v Commissioner, 73 F.3d 799 (8th Cir. 1996), which dealt with the creation of a capital asset (deposit account) which the insured would receive on termination of its insurance relationship net of paid losses.

Rev. Proc. 2002-75

Finally, the IRS published Rev. Proc. 2002-75, which indicates that the IRS will now provide guidance through ruling letters on captives relating to:

i. Whether there is requisite risk shifting and risk distribution necessary to constitute insurance for purposes of determining the deductibility of premiums as ordinary and necessary business expenses: and

ii. Whether the requisite risk shifting and risk distribution are present for determining whether an entity is an insurance company for federal income tax purposes.

Although acknowledging that rulings may now be considered, the Revenue Procedure does note that: "some questions arising in the context of a captive ruling request are so inherently factual... that contact should be made with the appropriate Service function prior to the preparation of such request to determine whether the Service will issue the requested ruling." Accordingly, although the topic is off the 'no ruling list', the IRS may still decline to rule based on the facts. The question obviously is whether the IRS will entertain requests that do not meet all of the requirements of the recently published revenue rulings or will use these merely as guides in their ruling posture.