(Also §§ 162, 801; 1.162–1, 1.801–3.)

Captive insurance; group captive. This ruling sets forth circumstances under which amounts paid to a group captive of unrelated insureds are deductible as insurance premiums and in which the group captive qualifies as an insurance company.

Rev. Rul. 2002–91

ISSUE

Whether a "group captive" formed by a relatively small group of unrelated businesses involved in a highly concentrated industry to provide insurance coverage is an insurance company within the meaning of § 831 of the Internal Revenue Code under the circumstances described below.

FACTS

X is one of a small group of unrelated businesses involved in one highly concentrated industry. Businesses involved in this industry face significant liability hazards. *X* and the other businesses involved in this industry are required by regulators to maintain adequate liability insurance coverage in order to continue to operate. Businesses that participate in this industry have sustained significant losses due to the occurrence of unusually severe loss events. As a result, affordable insurance coverage for businesses that participate in this industry is not available from commercial insurance companies.

X and a significant number of the businesses involved in this industry (Members) form a so-called "group captive" (*GC*) to provide insurance coverage for stated liability risks. *GC* provides insurance only to *X* and the other Members. The business operations of *GC* are separate from the business operation of each Member. *GC* is adequately capitalized.

No Member owns more than 15% of *GC*, and no Member has more than 15% of the vote on any corporate governance issue. In addition, no Member's individual risk insured by *GC* exceeds 15% of the total risk insured by *GC*. Thus, no one member controls *GC*.

GC issues insurance contracts and charges premiums for the insurance coverage provided under the contracts. *GC* uses recognized actuarial techniques, based, in part, on commercial rates for similar coverage, to determine the premiums to be charged to an individual Member.

GC pools all the premiums it receives in its general funds and pays claims out of those funds. *GC* investigates any claim made by a Member to determine the validity of the claim prior to making any payment on that claim. *GC* conducts no other business than the issuing and administering of insurance contracts.

No Member has any obligation to pay *GC* additional premiums if that Member's actual losses during any period of coverage exceed the premiums paid by that Member. No Member will be entitled to a refund of premiums paid if that Member's actual losses are lower than the premiums paid for coverage during any period. Premiums paid by any Member may be used to satisfy claims of the other Members. No Member that terminates its insurance coverage or sells its ownership interest in *GC* is required to make additional premium or capital payments to *GC* to cover losses in excess of its premiums paid. Moreover, no Member that terminates its coverage or disposes of its ownership interest in *GC* is entitled to a refund of premiums paid in excess of insured losses.

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.

Section 831(a) of the Code provides that taxes computed under section 11 are im-

posed for each tax year on the taxable income of every insurance company other than a life insurance company.

Section 1.801–3(a) provides that an insurance company is "a company whose primary and predominant business activity is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

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).

No court has held that a transaction between a parent and its wholly-owned subsidiary satisfies the requirements of risk shifting and risk distribution if only the risks of the parent are "insured." *See Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985); *Carnation Co. v. Commissioner*, 640 F.2d 1010 (9th Cir. 1981), *cert. denied*, 454 U.S. 965 (1981). However, courts have held that an arrangement between a parent and its subsidiary can constitute insurance because the parent's premiums are pooled with those of unrelated parties if (i) insurance risk is present, (ii) risk is shifted and distributed, and (iii) the transaction is of the type that is insurance in the commonly accepted sense. *See, e.g., Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993); *AMERCO, Inc. v. Commissioner*, 979 F.2d 162 (9th Cir. 1992).

Additional factors to be considered in determining whether a captive insurance transaction is insurance include: whether the parties that insured with the captive truly face hazards; whether premiums charged by the captive are based on commercial rates; whether the validity of claims was established before payments are made; and whether the captive's business operations and assets are kept separate from the business operations and assets of its shareholders. *Ocean Drilling & Exploration Co*. at 1151.

In Rev. Rul. 2001–31, 2001–1 C.B.1348, the Service stated that it will not invoke the economic family theory in Rev. Rul. 77–316 with respect to captive insurance arrangements. Rev. Rul. 2001–31 provides, however, that the Service may continue to challenge certain captive insurance transactions based on the facts and circumstances of each case.

Rev. Rul. 78–338, 1978–2 C.B.107, presented a situation in which 31 unrelated corporations created a group captive insurance company to provide those corporations with insurance that was not otherwise available. In that ruling, none of the unrelated corporations held a controlling interest in the group captive. In addition, no individual corporation's risk exceeded 5 percent of the total risks insured by the group captive. The Service concluded that because the corporations that owned, and were insured by, the group captive were not economically related, the economic risk of loss could be shifted and distributed among the shareholders that comprised the insured group.

X and the other Members face true insurable hazards. *X* and the other Members are required to maintain general liability insurance coverage in order to continue to operate in their industry. *X* and the other Members are unable to obtain affordable insurance from unrelated commercial insurers due to the occurrence of unusually severe loss events. Notwithstanding the fact that the group of Members is small, there is a real possibility that a Member will sustain a loss in excess of the premiums it paid. No individual Member will be reimbursed for premiums paid in excess of losses sustained by that Member. Finally, *X* and the other Members are unrelated. Therefore, the contracts issued by *GC* to *X* and the other Members are insurance contracts for federal income tax purposes, and the premiums paid by the Members are deductible under § 162.

GC is an entity separate from its owners. *GC* is adequately capitalized. *GC* issues insurance contracts, charges premiums, and pays claims after investigating the validity of the claim. *GC* will not engage in any business activities other than issuing and administering insurance contracts. Premiums charged by *GC* will be actuarially determined using recognized actuarial techniques, and will be based, in part, on commercial rates. As *GC*'s only business activity is the business of insurance, it is taxed as an insurance company.

HOLDING

The arrangement between *X* and *GC* constitutes insurance for federal income tax purposes, and the amounts paid as "insurance premiums" by *X* to *GC* pursuant to that arrangement are deductible as ordinary and necessary business expenses. *GC* is in the business of issuing insurance and will be treated as an insurance company taxable under § 831.

DRAFTING INFORMATION

The principal author of this revenue ruling is Melissa Luxner of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Ms. Luxner at (202) 622–3142 (not a toll-free call).