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# RETHINKING “INSURANCE,” ESPECIALLY AFTER AIG

BOBBY L. DEXTER<sup>†</sup>

## INTRODUCTION

In order to qualify as an “insurance company” for federal income tax purposes, both life insurance companies and their property and casualty counterparts must clear the hurdle of Section 816(a) of the Internal Revenue Code (“the Code”).<sup>1</sup> That section clarifies that insurance company status follows only if more than half of the entity’s business is the issuance of insurance or annuity contracts.<sup>2</sup> Although neither the Code nor the Treasury Regulations define “insurance,”<sup>3</sup> longstanding common law doctrine dictates that an arrangement will constitute insurance only if it incorporates requisite risk shifting and risk distribution.<sup>4</sup> A life insurance policyholder, for example, typically shifts the financial risk of his untimely demise to an insurance company by paying premiums.<sup>5</sup> In turn, the life insurance company broadly distributes that risk by collecting premiums from a large population of policyholders<sup>6</sup> so that any claims presented will not present a financial challenge to the company relative to the aggregate premiums received and set aside for claim payments.<sup>7</sup> In

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1. See I.R.C. § 816(a) (2006). With respect to property and casualty companies subject to tax under § 831, section 831(c) indicates that “insurance company” under § 831 has the same meaning as that set forth in § 816(a). I.R.C. § 831(c) (2006).

2. See § 816(a). A company may also qualify by reinsuring risks underwritten by other insurance companies. *See id.*

3. See Rev. Rul. 2005-40, 2005-2 C.B. 4, 2005 WL 1415557.

4. See *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941) (“Historically and commonly insurance involves risk-shifting and risk-distributing.”).

5. See *Clougherty Packing Co. v. Comm’r*, 811 F.2d 1297, 1300 (9th Cir. 1987) (“Shifting risk entails the transfer of the impact of a potential loss from the insured to the insurer. If the insured has shifted its risk to the insurer, then a loss by or a claim against the insured does not affect it because the loss is offset by the proceeds of an insurance payment.”); *Spring Canyon Coal Co. v. Comm’r*, 43 F.2d 78, 80 (10th Cir. 1930) (noting that the taxpayer would have shifted the risk had it paid the premium).

6. See *Clougherty Packing Co.*, 811 F.2d at 1300 (“Insuring many independent risks in return for numerous premiums serves to distribute risk.”).

7. See *id.* As an interesting historical aside, several of the initial founders of the North Carolina Mutual Life Insurance Company (which currently has insurance in force exceeding \$12 billion and is the oldest and largest historically African-American-owned life insurance company in the United States, see N.C. Mut. Life Ins. Co., <http://www.ncmutuallife.com/newsite/pages/about.html> (last visited Sept. 7, 2009)) had to pool their own funds after a quick meeting in the rear of a barber shop in order to pay the \$40 death benefit claim of a widow. See 2 ENCYCLOPEDIA OF AFRICAN AMERICAN BUSINESS 519 (Jessie Carney Smith ed., 2006).

adopting that approach, the company takes advantage of the so-called “law of large numbers.” Using reliable probability data, it can generally coordinate premium receipts with predicted losses.<sup>8</sup> With a population of policyholders in a life insurance pool sufficiently large and varied, *predicted* mortality rates will roughly correlate with the population’s *actual* mortality rates,<sup>9</sup> and the company can generally pay benefits as they come due over the long term without going broke in the short term.<sup>10</sup>

For many companies, satisfying the qualitative and quantitative “insurance” standards presents no problem. Accordingly, the company does not question its status as an insurance company. Logically, those policyholders entitled to deduct premiums paid to insurance companies as ordinary and necessary business expenses also have no reason to question the tax deductibility of the payments made.<sup>11</sup> Historically, however, there are prominent victims of the risk shifting/distributing standard, entities known in the business world as “captive” insurance companies.<sup>12</sup> Generally speaking, a captive insurance company (which is routinely organized and operated as a wholly-owned subsidiary of a parent entity) is often created to provide coverage to a business that cannot secure the insurance it needs from the marketplace, or can only secure such insurance at a prohibitive cost<sup>13</sup> (for example, a company operating nuclear reactors in an urban area and needing insurance against the risk of a meltdown). Legitimate business needs notwithstanding, the Internal Revenue Service (“IRS” or “Service”) has long been hostile to the notion that a wholly-owned subsidiary can insure its parent company<sup>14</sup> and, accordingly, that the payment of a premium from a parent to its captive insurer subsidiary qualifies as a deductible ordinary and necessary business expense. Attempts to resolve this issue have, not surprisingly, resulted in substantial judicial activity, a series of IRS pronouncements, and a healthy body of professional and scholarly commentary.<sup>15</sup> For some time, the Service

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8. See *Clougherty Packing Co.*, 811 F.2d at 1300.

9. See *id.* (linking the law of large numbers, a statistical phenomenon, and the concept of risk distribution).

10. See *id.* (“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. . . . 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.”).

11. See Treas. Reg. § 1.162-1(a) (as amended in 1993) (“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 . . .”).

12. For a basic definition of “captive insurance company,” see Gordon A. Schaller & Scott A. Harshman, *Use of Captive Insurance Companies in Estate Planning*, 33 AM. C. TR. & EST. COUNS. J. 252, 252 (2008). Application of the traditional “insurance” test to captive insurance companies is discussed in Part II of this Article.

13. See *id.*

14. See, e.g., Rev. Rul. 77-316, 1977-2 C.B. 53, 1977 WL 43573, *obsoleted* by Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232. As discussed in greater detail in Part II, the prior ruling concluded, inter alia, that a parent had not entered into an insurance relationship with its wholly-owned insurance subsidiary.

15. See, e.g., *Malone & Hyde, Inc. v. Comm’r*, 62 F.3d 835, 840–43 (6th Cir. 1995); *Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135, 1153–54 (Fed. Cir. 1993); *Amerco, Inc.*

reasoned that a premium payment from one related entity to another in its affiliated or consolidated group for insurance simply did not shift any risk because, in the end, the financial burden of loss coverage did not leave "the economic family."<sup>16</sup> Without risk shifting, no insurance arrangement existed, and a tax deduction for a premium payment from the entity to its fellow group member was deemed inappropriate.<sup>17</sup> Even in the wake of judicial attack<sup>18</sup> and scholarly criticism,<sup>19</sup> the Service persistently appeals to traditional risk shifting and risk distributing standards with regard to the tax deductibility of insurance premium payments.<sup>20</sup>

Whether stating its opposition to a given arrangement under the rubric of risk shifting/distributing or "economic family," the Service seeks, at root, to prevent the taking of a deduction for what it sees as merely a contribution to a contingency reserve. Its opposition is not unwavering

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v. Comm'r, 979 F.2d 162, 164, 168 (9th Cir. 1992); Harper Group v. Comm'r, 979 F.2d 1341, 1342 (9th Cir. 1992); Sears, Roebuck & Co. v. Comm'r, 972 F.2d 858, 860–62 (7th Cir. 1992); Humana, Inc. v. Comm'r, 881 F.2d 247, 251–52 (6th Cir. 1989); Clougherty Packing Co. v. Comm'r, 811 F.2d 1297, 1305–07 (9th Cir. 1987); Beech Aircraft Corp. v. United States, 797 F.2d 920, 922–23 (10th Cir. 1986); Carnation Co. v. Comm'r, 640 F.2d 1010, 1013 (9th Cir. 1981); Hosp. Corp. of Am. & Subsidiaries v. Comm'r, 74 T.C.M. (CCH) 1020, 1997 WL 663283, at \*30, \*35 (1997); Kidde Indus., Inc. v. United States, 40 Fed. Cl. 42, 56–58 (1997), *appeal dismissed per stipulation*, 194 F.3d 1330 (Fed. Cir. 1999) (unpublished table decision); Gulf Oil Corp. v. Comm'r, 89 T.C. 1010, 1025–29 (1987); Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946; Rev. Rul. 2005-40, 2005-2 C.B. 4, 2005 WL 1415557; Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232; Rev. Rul. 78-338, 1978-2 C.B. 107, 1978 WL 41909; Rev. Rul. 77-316, 1977-2 C.B. 53, 1977 WL 43573, *obsoleted by* Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232; I.R.S. Priv. Ltr. Rul. 96-24-028 (June 14, 1996), 1996 WL 326435; James A. Christopherson, *The Captive Medical Malpractice Insurance Company Alternative*, 5 ANNALS HEALTH L. 121, 125–32 (1996); Karen Gantt, *Federal Tax Treatment of Medical Malpractice Insurance Alternatives for Nonprofits*, 52 DRAKE L. REV. 495, 514–21 (2004); Ray A. Knight & Lee G. Knight, *Disregarding the Separate Corporate Entity of Captive Insurance Companies: A Violation of the Moline Properties Doctrine*, 14 J. CORP. L. 399, 405–09 (1989); Robert W. Minto, Jr., *Captives and RRG'S in the Reinsurance Environment*, 889 PLI/COMM 837, 843–44 (2006); Schaller & Harshman, *supra* note 12, at 254–58; F. Roy Sedore, *Insurance Premium Deductibility*, 779 PLI/TAX 1061, 1067–69 (2007); Stuart R. Singer, *When the Internal Revenue Service Abuses the System: Captive Insurance Companies and the Delusion of the Economic Family*, 10 VA. TAX REV. 113, 160–63 (1990); Scott A. Taylor, *Taxing Captive Insurance: A New Solution for an Old Problem*, 42 TAX LAW. 859 *passim* (1989); Donald Arthur Winslow, *Tax Avoidance and the Definition of Insurance: The Continuing Examination of Captive Insurance Companies*, 40 CASE W. RES. L. REV. 79, 110–14 (1990); Armando Gomez, Note, *A Practical Approach to the Captive Insurance Problem: Sears, Roebuck & Co. v. Commissioner*, 46 TAX LAW. 619, 620–23 (1993).

16. See Rev. Rul. 77-316, 1977-2 C.B. 53, 1977 WL 43573, *obsoleted by* Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232.

17. See *id.*

18. See, e.g., Sears, Roebuck & Co. v. Comm'r, 972 F.2d 858, 861 (7th Cir.) (indicating that in *Le Gierse* the Supreme Court "was not writing a definition for all seasons and had no reason to"). The court went on to say that "it is impossible to see how risk shifting can be a *sine qua non* of 'insurance.'" *Id.* at 862.

19. See, e.g., Singer, *supra* note 15, at 119 (describing the risk shifting/distributing standard as dicta from dated U.S. Supreme Court authority and the Service's economic family theory as an invention); Knight & Knight, *supra* note 15, at 417 (arguing that the "economic family" theory—advanced by the Service in concluding that risk shifting and distributing were absent in some transactions—cannot be reconciled with the *Moline Properties* doctrine); Note, *The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance*, 59 YALE L.J. 780, 782 (1950) (describing the risk shifting/distributing test as "cryptic").

20. See, e.g., Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946; Rev. Rul. 2005-40, 2005-2 C.B. 4, 2005 WL 1415557.

because various Code provisions explicitly sanction the taking of deductions for additions to reserves for *some* companies. For example, life insurance companies<sup>21</sup> facing ultimate liability for a given death benefit and nuclear energy companies<sup>22</sup> facing decommissioning obligations may properly deduct premium payments made into their own reserves. Yet, despite the fact that establishing substantial financial reserves is a wise move for any responsible company, the ability to do so at the expense of the United States Treasury is not a matter of easily obtained Congressional grace. Should it be?

This Article asks and attempts to answer questions of doctrine and policy. Should the “reserving function” be limited, as a matter of sound tax policy, to a discrete subset of taxpayers operating in industries of relative certainty (e.g., death, decommissioning, and the like), or should Congress allow deductions for limited contributions to contingency reserves more broadly? If one deems a general contingency reserve regime fiscally untenable, then can one rationally consider allowing gradual, limited, and regulated reserving for companies “too big to fail?” Or, does that approach ask way too much for financial exigencies that merely *might* occur? Also, as a purely doctrinal matter, should the Service altogether abandon its traditional, yet utterly shakable, risk shifting/distributing approach, or reserve that approach for companies that could be served well enough by the established insurance markets but merely wish to use a captive insurance company to reduce overall operating expenses (i.e., leave *this* to experts, and don’t try it at *your* office)?

Given the posture of various courts and commentators, one can certainly argue the case for tweaking the “insurance” test to accommodate individual entities (or affiliated groups) with risks that are both statistically “certain-to-occur-at-some-point” and sufficiently numerous, homogenous, and independent<sup>23</sup> to take advantage of the law of large numbers without the involvement of an entity outside the affiliated group (for example, a single corporate entity or group with a massive fleet of service vehicles needing some form of insurance coverage).

In light of recent economic challenges,<sup>24</sup> now may be a good time to reconsider the permissible ambit and optimal scope of the reserving function in the tax arena. We live in a time when one hungry corporate Goliath grumbles impatiently behind its household name big brother, each

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21. I.R.C. § 805(a)(2) (2006).

22. See I.R.C. § 468(a)(1)(A) (2006).

23. See generally *Gulf Oil Corp. v. Comm’r*, 89 T.C. 1010, 1025 n.9 (1987) (“As a theoretical matter, risk distribution or pooling requires: (i) Mass - \* \* \* , (ii) Homogeneity - \* \* \* , and (iii) Independence - \* \* \* . If these requirements are met to some minimum extent, the principles of average and large numbers operate . . .”).

24. See Adam Zagorin & Michael Weisskopf, *Inside the Breakdown at the SEC*, TIME, Mar. 9, 2009, at 34, available at 2009 WLNR 3721270 (describing current economic conditions as “the worst financial crisis since the Great Depression”).

queuing for its slice of federal bailout.<sup>25</sup> Neither is alone. Americans are also grumbling. They rightfully ask why they should be on the hook for resuscitating companies that should have never been allowed to wade so far into the deep.<sup>26</sup> With justified skepticism, they question the wisdom of bailing out companies with their hard-earned tax dollars<sup>27</sup> while corporate executives, without the restraining leash of rapt oversight,<sup>28</sup> recline on private jets and make their way to the next boondoggle hoping that the redecoration of their offices will have been completed by the time they get back.<sup>29</sup> Given the potential negative economic ramifications for the broader U.S. economy, maybe certain companies were indeed "too big to fail"<sup>30</sup>—but certainly they were not too big to strategically reserve some portion of their profits instead of routinely showering millions<sup>31</sup> on a select few for contract-based or "performance-based"<sup>32</sup> compensation. Would it not be better for American taxpayers to collectively suffer corporate deductions for the gradual creation of a *limited*

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25. See, e.g., Bill Saporito, *Is This Detroit's Last Winter?*, TIME, Dec. 15, 2008, at 34, available at 2008 WLNR 23306940 (indicating that American International Group, Inc. ("AIG") and Citigroup had received multi-billion dollar bailouts and that Ford, General Motors, and Chrysler were hoping to receive federal bailouts). Some companies have returned several times for additional assistance. See Francesco Guerrera, *AIG Considers Break-up in Bid to Stay Afloat*, FIN. TIMES, Feb. 25, 2009, at 1 (reporting that AIG might be broken up as part of a radical restructuring of the company and noting that, at the time, the government had bailed out AIG three times in five months).

26. See, e.g., Saporito, *supra* note 25, at 34 (highlighting situational irony by pointing out that "AIG torpedoed the entire economy and gets a \$150 billion handout; Citigroup takes risks no sane manufacturing company would even contemplate and is rewarded with a \$20 billion federal bailout").

27. Current proposals direct trillions of dollars at recovery efforts. See John Fritze, *Trillions Aimed at Recovery*, USA TODAY, Feb. 11, 2009, at 1A, available at 2009 WLNR 2668766 ("The White House unveiled a sweeping proposal . . . to spend as much as \$2 trillion in public and private funds to prop up the nation's financial system as the Senate narrowly approved an \$838 billion stimulus intended to jump-start the failing economy.").

28. See, e.g., Alan Beattie & Edward Luce, *Obama Gets Tough on Pay for Executives*, FIN. TIMES, Feb. 5, 2009, at 1 (noting U.S. President Barack Obama's disgust at various Wall Street excesses and reporting that Wall Street executives received \$20 billion in bonuses in 2008 despite massive market losses); see also Sarah O'Connor, *Top Senators Rap Fed Over AIG Rescue*, FIN. TIMES, Mar. 6, 2009, at 3 (noting the warnings of the U.S. Senate's banking committee with respect to future financial support of AIG given the "failure to reveal how the \$163bn injected into the insurance company has been spent").

29. See Mark DeCambre & Paul Tharp, *Goofy Getaway—AIG Ripped for Senseless Spending*, N.Y. POST, Oct. 10, 2008, at 34, available at 2008 WLNR 19335564; see also Terry Keenan, *The Reign of Thain Was Mainly Just a Pain*, N.Y. POST, Jan. 25, 2009, at 32, available at 2009 WLNR 1631465.

30. Many consider AIG the quintessential company that is "too big to fail." See, e.g., Bill Saporito, *How AIG Became Too Big to Fail*, TIME, Mar. 30, 2009, at 24, available at 2009 WLNR 5204402.

31. See, e.g., Mimi Hall et al., *Critics Blast AIG as Flap Escalates over Bonuses*, USA TODAY, Mar. 17, 2009, at 1A, available at 2009 WLNR 5033330 (reporting growing public disgust with corporate America and indicating that bonuses paid to certain AIG executives were negotiated in early 2008). Apparently, compensation restraint is now a reality with respect to certain federal funds recipients. See Beattie & Luce, *supra* note 28, at 1 (reporting that going forward, executives at companies receiving a certain level of federal assistance would receive no more than \$500,000 per year as compensation).

32. Although I.R.C. § 162(m)(1) generally disallows a deduction in the publicly-held company context for "applicable employee remuneration" above \$1,000,000, certain performance based compensation is excluded from the definition of "applicable employee remuneration" under § 162(m)(4)(C). I.R.C. § 162(m) (2006) (limiting deductions for compensation in some contexts).

contingency reserve with which the companies could head off full-scale financial havoc at the pass (or at least make a *hefty* contribution to their own bailout), rather than being forced to ante up a lump sum on short order, bear the brunt of the various agency costs inherent in the corporate form<sup>33</sup> (enhanced and exacerbated by gargantuan bailout infusions), and shoulder all of the attendant repayment risks at the same time?

Turning first to the doctrinal inquiry, Part I of this Article glances back to the common law origin of the risk shifting/distributing standard and reaches back a bit further, to highlight early authority in which the Service frowns harshly on taxpayer deductions for self-reserving activity.

To flesh out evolving doctrinal contours and set the stage for a critique, Part II shifts the focus to the captive insurance company context where much—if not most—of the litigation regarding risk shifting/distributing has taken place. In addition to addressing the rise and fall of the economic family argument empire, Part II also explains which captive insurance arrangements work and highlights the Service's most recent pronouncements that effectively delineate its current litigation position.

Part III briefly summarizes prior criticism of the risk shifting/distributing standards, both of which have been gradually weakened by courts and commentators, before going on to explore the question of whether recent IRS pronouncements reflect a new and aggressive elevation of form over substance in the captive insurance arena. Part III also notes that current business realities, coupled with the nefarious practices that many insurance companies habitually employ, compel some questioning of the utility of the risk shifting/distributing standards. Arguably, these standards best apply in more idealistic settings.

Part IV presents and assesses a two-pronged proposal for reform: the allowance of both contextual self-insuring (which seeks to modify the prevailing standard), and utilitarian contingency reserving (which would permit regulated contingency reserving using existing nuclear decom-

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33. One commentator notes the following:

Agency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents. In turn, shirking is defined to include any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes.

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... [A]gency costs are the inevitable consequence of vesting discretion in someone other than the residual claimant.

STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 35–37 (2002). Directors and officers of companies are often protected from liability for mismanagement of the business and affairs of a given company. Indeed, those individuals often enjoy several layers of protection, given that they tend to be covered by both primary policies and several “excess” policies (i.e., those that will generally pay after primary policy limits have been reached). See Eric S. Connuck, *Excess D&O Insurance: The Exhaustion by Payment Condition*, *BUS. L. TODAY*, Sept.–Oct. 2008, at 45.

missioning reserve fund rules and procedures as a basic model). Part V sets forth concluding thoughts.

### I. TRADITIONAL DEFINITIONS: "INSURANCE COMPANY" AND "INSURANCE"

Insurance companies, whether life and health companies or property and casualty companies, commonly have substantial amounts of both underwriting income (e.g., premium payments, fees, and assessments)<sup>34</sup> and investment income (e.g., interest, dividends, and rents).<sup>35</sup> At the same time, these companies, because they perform an important societal function, enjoy favorable treatment under the federal income tax laws. Among other things, they have the ability to take current deductions for increases in certain internal reserves.<sup>36</sup> Reasoning that an entity devoted primarily to the generation of investment income should not enjoy unduly favorable tax treatment, Congress requires that an entity seeking to qualify as an "insurance company" for federal income tax purposes satisfy both qualitative and quantitative standards. Speaking in general terms, the company must be in the business of issuing insurance or annuity contracts,<sup>37</sup> and that business activity must constitute more than half of all the company's total business.<sup>38</sup>

Although the "more than half" quantitative standard has long applied to life insurance company determinations, non-life companies (such as property and casualty) could, at least until recently, qualify as insurance companies by establishing that the issuing of insurance contracts was their "primary and predominant" business activity.<sup>39</sup> By way of the Pension Funding Equity Act of 2004,<sup>40</sup> Congress eliminated the quantitative standard duality and now requires that *all* insurance companies satisfy the "more than half" standard.<sup>41</sup> Unfortunately, Congress did not use that legislation as a vehicle to clarify the precise meaning of "insurance."

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34. See KENNETH BLACK, JR. & HAROLD D. SKIPPER, JR., *LIFE AND HEALTH INSURANCE* 971 (13th ed. 2000).

35. See I.R.C. § 832(b)(2) (2006) (listing specific items of investment income).

36. Life insurance companies are entitled to a deduction for increasing their life insurance reserves. See I.R.C. §§ 805(a)(2), 807(b), (c)(1) (2006). Other insurance companies are allowed adjustments in calculating underwriting income for increases in unearned premiums and unpaid loss reserves. See § 832(b)(3), (b)(4)(B), (b)(5)(A)(ii).

37. The company may also qualify as an insurance company by reinsuring risks which are underwritten by insurance companies. I.R.C. § 816(a)(2) (2006). For a basic application of the qualitative standard, see *Allied Fid. Corp. v. Comm'r*, 572 F.2d 1190, 1194 (7th Cir. 1978) (holding that a wholly-owned subsidiary was not an insurance company because the character of its primary business, the writing of bail bonds, was not the writing of contracts of insurance).

38. § 816(a)(2).

39. Treas. Reg. § 1.801-3(a)(1) (as amended in 1972). Thus, it was simply easier for a property and casualty company to qualify as an insurance company. See H.R. REP. NO. 98-432, pt. 2, at 1402-04 (1984), *reprinted in* 1984 U.S.C.A.N. 697, 1047 (indicating Congress's intent to create a standard more strict and precise for life insurance company characterization).

40. Pension Funding Equity Act of 2004, Pub L. No. 108-218, § 206, 118 Stat. 596, 611 (codified as amended at I.R.C. § 831(c) (2006)).

41. See I.R.C. §§ 816(a)(2), 831(c).



Thus, as a traditional starting point, we are left with the risk shifting/distributing standards set forth in 1941, in the landmark case of *Helvering v. Le Gierse*.<sup>42</sup>

Less than a month before her death, 80-year-old Edyth Le Gierse purchased both a single-premium life insurance contract and an annuity from the Connecticut General Life Insurance Company ("Connecticut General").<sup>43</sup> Together, the contracts obligated Connecticut General to pay her \$589.80/year for the remainder of her life and a \$25,000 death benefit to her daughter, the designated beneficiary.<sup>44</sup> Edyth executed the contracts and paid \$27,125 in a lump sum to Connecticut General.<sup>45</sup> Ultimately, it was hoped that these arrangements would allow the exclusion of the \$25,000 death benefit from Edyth's gross estate for federal estate tax purposes.<sup>46</sup> Concluding that the death benefits should not have been excluded from Edyth's gross estate, the Commissioner asserted a deficiency, but was forced to pursue the case to the U.S. Supreme Court before achieving the desired result.<sup>47</sup>

Writing for the majority, Justice Murphy noted that the parties complied in all respects with standard contractual formalities,<sup>48</sup> but went on to emphasize that "the [purported insurance] amounts must be received as the result of a transaction which involved an actual 'insurance risk' at the time the transaction was executed. Historically and commonly insurance involves risk-shifting and risk-distributing."<sup>49</sup> Viewing the transaction holistically, the Court concluded that the life insurance contract would not have been issued without the annuity contract and that "[c]onsidered together, the contracts wholly fail to spell out any element of insurance risk."<sup>50</sup> The Court emphasized that all contract consideration was prepaid,<sup>51</sup> and any risk that the amounts paid by Edyth Le Gierse would not generate earnings sufficient to cover the annuity payments due her was an *investment* risk, not an insurance risk.<sup>52</sup> Accordingly, the Court held that the \$25,000 should have been included in the decedent's gross estate.<sup>53</sup>

Although there is only so much to be learned about the fundamental nature of insurance from *Le Gierse*—namely, that insurance is not the

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42. 312 U.S. 531 (1941).

43. *Id.* at 536.

44. *Id.*

45. *Id.*

46. *See id.* at 537–38.

47. *See id.* at 537.

48. *See id.*

49. *Id.* at 539.

50. *Id.* at 541.

51. *Id.* at 542.

52. *Id.*; *see also* *Comm'r v. Treganowan*, 183 F.2d 288, 290 (2d Cir. 1950) ("[T]here is no risk unless there is uncertainty or, to use a better term, fortuitousness.").

53. *See Le Gierse*, 312 U.S. at 542.

equivalent of a mere investment risk<sup>54</sup>—the opinion serves as landmark decision because it articulates the risk-shifting and risk-distributing standards.<sup>55</sup> Even though the *Le Gierse* opinion was criticized as cryptic soon after issuance of the opinion<sup>56</sup> and weakened, to some extent, by subsequent judicial developments<sup>57</sup> and scholarly commentary,<sup>58</sup> the two-part test has managed to survive for decades.<sup>59</sup> Whether this sturdy, conceptual immunity is a good thing, whether its application remains justifiable, and whether the standard has weathered steady criticism in worse condition than its proponents are willing to acknowledge, all remain open questions to be addressed in the following Parts of this Article.

There remains a need to separate true “insurance” companies entitled to favorable tax treatment from non-insurance companies that fail to qualify for favorable treatment. Thus, some gate-keeping standard must be in place. That standard must, however, be rational, and ideally should be fully consistent with sound tax policy. Further, compliance standards should be readily ascertainable, given that a company that unwittingly fails the standard may find itself in an unexpected or unworkable tax environment, and those paying purported premiums may suddenly find that deduction of the amount was improper.

Whether deservedly or not, captive insurance companies and their premium-paying organizers have historically been the predominant vic-

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54. See *id.* For a more recent statement of this principle, see Rev. Rul. 89-96, 1989-2 C.B. 114, 1989 WL 550753 (emphasizing that the mere assumption of an investment risk cannot create an insurance contract for federal income tax purposes).

55. See, e.g., Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946 (citing *Le Gierse* and noting that it is United States Supreme Court precedent).

56. See Note, *supra* note 19, at 782. The Note also argues that in *Estate of Strauss*, the Tax Court erred in concluding that risk-shifting had not occurred and that the death benefit plan at issue did not constitute “insurance.” See *id.* at 784–86. The Tax Court was later reversed by the Court of Appeals for the Second Circuit. *Treganowan*, 183 F.2d at 293.

57. See *Malone & Hyde, Inc. v. Comm’r*, 62 F.3d 835, 838–39 (6th Cir. 1995); *Ocean Drill- ing & Exploration Co. v. United States*, 988 F.2d 1135, 1144–46 (Fed. Cir. 1993); *Amerco, Inc. v. Comm’r*, 979 F.2d 162, 164–65 (9th Cir. 1992); *Harper Group v. Comm’r*, 979 F.2d 1341, 1342 (9th Cir. 1992); *Sears, Roebuck & Co. v. Comm’r*, 972 F.2d 858, 861–62 (7th Cir. 1992); *Humana, Inc. v. Comm’r*, 881 F.2d 247, 255 (6th Cir. 1989); *Beech Aircraft Corp. v. United States*, 797 F.2d 920, 922 (10th Cir. 1986); *Carnation Co. v. Comm’r*, 640 F.2d 1010, 1013 (9th Cir. 1981); *Kidde Indus., Inc. v. United States*, 40 Fed. Cl. 42, 56–57 (1997), *appeal dismissed per stipulation*, 194 F.3d 1330 (Fed. Cir. 1999) (unpublished table decision); *Gulf Oil Corp. v. Comm’r*, 89 T.C. 1010, 1025–27 (1987); Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946; Rev. Rul. 2005-40, 2005-2 C.B. 4, 2005 WL 1415557; Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232; Rev. Rul. 78-338, 1978-2 C.B. 107, 1978 WL 41909; Rev. Rul. 77-316, 1977-2 C.B. 53, 1977 WL 43573, *obsoleted* by Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232; I.R.S. Priv. Ltr. Rul. 96-24-028 (June 14, 1996), 1996 WL 326435.

58. See *Christopherson, supra* note 15, at 127–28; *Gantt, supra* note 15, at 517–20; *Gomez, supra* note 15, at 624–28; *Knight & Knight, supra* note 15, at 409; *Minto, supra* note 15, at 841–47; *Schaller & Harshman, supra* note 12, at 254–55; *Singer, supra* note 15, at 123, 133–34; *Taylor, supra* note 15 *passim*; *Winslow, supra* note 15, at 94–99.

59. See, e.g., Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946 (emphasizing that risk-shifting and risk-distribution must be present in order for an arrangement to constitute insurance for federal income tax purposes).

tims of the two-part “insurance” test.<sup>60</sup> To some extent, their bad luck was fortuitous because it resulted in a degree of healthy doctrinal modification<sup>61</sup> and, at the same time, provided an accessible setting for thorough doctrinal assessment.

Part II of this Article provides an in-depth examination of the rigorous attempt to apply the risk shifting/distributing standard in the captive insurance company context, the industry’s creative responses, the conceptual concessions made by the Service, and the structural limits imposed on taxpayers. Part II closes by presenting the doctrinal status quo and discussing two recent IRS pronouncements that clarify the Service’s current litigating position and serve as analytical segues to the critique presented in Part III and proposals presented in Part IV.

## II. DOCTRINAL EVOLUTION AND THE STATUS QUO: CAPTIVE INSURANCE COMPANIES

### A. *Captive Insurance Companies—General Description and the Lurking Problem*

Although it is easy to think of captive insurance companies existing only as wholly-owned domestic subsidiaries providing coverage to their parent or brother-sister entities (a “pure” captive), in reality captive insurance companies take many forms.<sup>62</sup> In addition to those organized in the United States, pure captives are commonly organized offshore in foreign jurisdictions.<sup>63</sup> Often this is because foreign jurisdictions have less demanding standards with respect to insurance company formation

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60. See, e.g., *Malone & Hyde, Inc. v. Comm’r*, 62 F.3d 835, 840 (6th Cir. 1995) (holding that “insurance” cannot exist between a “sham” captive and insureds in its corporate family); *Carnation Co. v. Comm’r*, 640 F.2d 1010, 1012–13 (9th Cir. 1981) (holding that no “insurance” exists if a company’s risks are purportedly insured with an unrelated entity which reinsures those risks with the insured’s wholly-owned insurance subsidiary); Rev. Rul. 77-316, 1977-2 C.B. 53, 1977 WL 43573 (setting forth the “economic family” theory as justification for denying deductions with respect to amounts paid to captive insurance companies—i.e., those within the same corporate family—because such amounts did not constitute “insurance” premiums), *obsoleted* by Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232.

61. See, e.g., *Amerco, Inc. v. Comm’r*, 979 F.2d 162, 166, 168 (9th Cir. 1992) (holding that a parent, and a brother-sister entity, can have a true insurance transaction with the parent’s captive insurance company when the captive has substantial outside insurance business); *Harper Group v. Comm’r*, 979 F.2d 1341, 1342 (9th Cir. 1992) (holding that a captive insurance company with 29%–33% of its business coming from unrelated insureds could have true “insurance” relationships with members of its corporate family); *Sears, Roebuck & Co. v. Comm’r*, 972 F.2d 858, 860, 864 (7th Cir. 1992) (holding that Sears purchased “insurance” from its wholly-owned subsidiary, Allstate, and noting that 99.75% of Allstate’s business came from other sources); *Humana, Inc. v. Comm’r*, 881 F.2d 247, 257 (6th Cir. 1989) (emphasizing the *Moline Properties* mandate and holding that there was risk-shifting and risk-distributing when a captive insured the risks of brother-sister entities); Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232 (noting that the Service “will no longer raise the ‘economic family theory,’” set forth in Rev. Rul. 77-316, “in addressing whether captive insurance transactions constitute valid insurance” and indicating that “the Service will address such transactions on a case-by-case basis”).

62. See, e.g., Minto, *supra* note 15, at 841–42.

63. See Schaller & Harshman, *supra* note 12, at 252.

and lower levels of ongoing oversight.<sup>64</sup> Several businesses may come together to form a "group captive" (which insures the various liability risks of its owners/members),<sup>65</sup> and it is not uncommon for a given business (whose clients routinely need to secure some form of insurance) to form a "sponsored captive"<sup>66</sup> for the benefit of its clients. In that setting, the sponsored captive creates segregated financial cells to isolate and thereby protect individual client risks from the risks of others.<sup>67</sup>

Whatever the form, companies generally resort to a captive insurance arrangement to secure coverage that is either unavailable or difficult to obtain at a reasonable price (for example, insurance for medical malpractice,<sup>68</sup> latent construction defects, or potential earthquake damage<sup>69</sup>). Alternatively, companies may also resort to a captive for financial or strategic reasons,<sup>70</sup> such as to lower the cost of insurance or invest the insurance company's reserves.<sup>71</sup> These legitimate, rational business purposes have never managed, on their own, to establish the existence of an "insurance arrangement"<sup>72</sup> under the *Le Gierse* standards.

Indeed, captive insurance company arrangements remain consistently vulnerable to attack because a company purportedly paying a premium to the captive bears an uncomfortable resemblance to a company contributing to a contingency reserve, and the Service has long been hostile to the notion that a taxpayer deserves a deduction for *that*.<sup>73</sup> For example, in *Spring Canyon Coal Co. v. Commissioner*,<sup>74</sup> the taxpayer operated a coal mine and was obligated by state law to obtain workmen's compensation insurance either by securing it from a private carrier, participating in the state insurance fund, or by demonstrating an independent ability to pay claims.<sup>75</sup> Opting to take the latter route, the taxpayer estab-

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64. See *id.* at 253–54; see also Christopherson, *supra* note 15, at 132–33 (pointing out that offshore formation of captives is common because offshore domiciles have lower capitalization requirements, more lax reporting requirements, and a less stringent regulatory environment).

65. See Minto, *supra* note 15, at 842.

66. See *id.*

67. *Id.*

68. See Gantt, *supra* note 15, at 498–500 (noting that medical malpractice insurance needs have prompted many responses, including the formation of captive insurance companies).

69. See Schaller & Harshman, *supra* note 12, at 252.

70. See Christopherson, *supra* note 15, at 122 (stating that, among other reasons, health care providers may form a captive to control premium and capital investment and obtain coverage broader than that which is commercially available). Christopherson also notes that by forming a captive, a company should be able to minimize administrative costs, eliminate third-party profit margins, reduce loss exposures, and improve claim management. See *id.* at 123.

71. See Schaller & Harshman, *supra* note 12, at 252.

72. See *Beech Aircraft Corp. v. United States*, 797 F.2d 920, 923 (10th Cir. 1986) (emphasizing that the legitimacy of the business purpose behind forming the captive does not establish risk-shifting and risk-distributing and does not foreclose a finding of the absence of either).

73. See *Gulf Oil Corp. v. Comm'r*, 89 T.C. 1010, 1024 (1987) ("Although technically transfer of risk may occur when a captive is involved that is a separate, viable entity, financially capable of meeting its obligations, we simply declined to recognize it as such when the arrangement was merely in substance the equivalent of a reserve for losses or self-insurance.").

74. 43 F.2d 78 (10th Cir. 1930).

75. *Id.* at 78.

lished a "Welfare or Compensation Insurance Fund"<sup>76</sup> and ultimately sought to deduct amounts contributed to the fund as ordinary and necessary business expenses.<sup>77</sup> The Service objected, claiming the amounts were not "expenses" but rather "reserves" set aside for contingent losses.<sup>78</sup> Siding with the Commissioner, the Court of Appeals for the Tenth Circuit held that:

The whole object of self-insurance is to avoid the expense of insurance premiums. If the petitioner had elected to insure its risks in the state fund or a private company, it would have expended the premium and shifted the risk; instead, it retained the risk and kept the premium. Having elected not to expend the premium, it cannot charge a corresponding sum as an "expense." . . . [T]he petitioner is not entitled to deduct as an expense a sum of money which it might have expended for insurance premiums, but did not.<sup>79</sup>

The dilemma faced by taxpayers in situations like those in *Spring Canyon Coal Company* did not resolve itself over time. Aggressively seeking (or legally obligated) to acquire some form of designated insurance, and determined to do so in a manner they deemed financially feasible, companies were rather creative in their efforts to get both the coverage and the benefit of something akin to a premium payment deduction.<sup>80</sup> The Service did not sit idly by. To the extent that companies steered clear of naked contingency fund reserving and moved towards the use of separately-incorporated but wholly-owned "insurance" entities, the Service countered by creating or appealing to broad-sweeping doctrines to disallow deductions for what it considered contingency reserve contributions.<sup>81</sup> For decades, the "economic family" theory was the Service's weapon of choice.<sup>82</sup>

### *B. The Rise and Fall of the "Economic Family" Argument Empire*

The Service formally set forth its "economic family" theory in Revenue Ruling 77-316<sup>83</sup> by presenting and assessing three hypothetical situations. In each situation, a new, wholly-owned foreign insurance subsidiary provides fire and other casualty insurance to members of its corporate family.

76. *Id.* at 79.

77. *Id.*

78. *Id.*

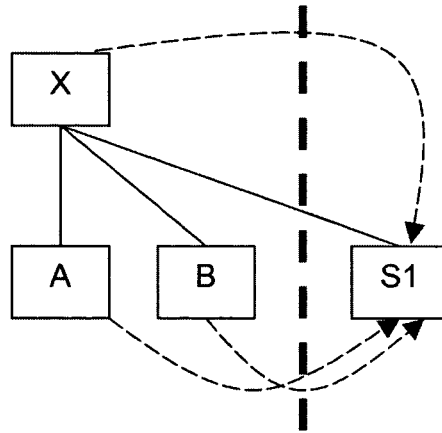
79. *Id.* at 80.

80. *See, e.g.,* *Carnation Co. v. Comm'r*, 640 F.2d 1010, 1013 (9th Cir. 1981) (using a fronting company obligated to reinsure with a wholly-owned captive insurance subsidiary and using a contingent capitalization agreement to persuade the fronting company).

81. *See* Rev. Rul. 77-316, 1977-2 C.B. 53, 1977 WL 43573 (announcing the "economic family" theory), *obsoleted by* Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232.

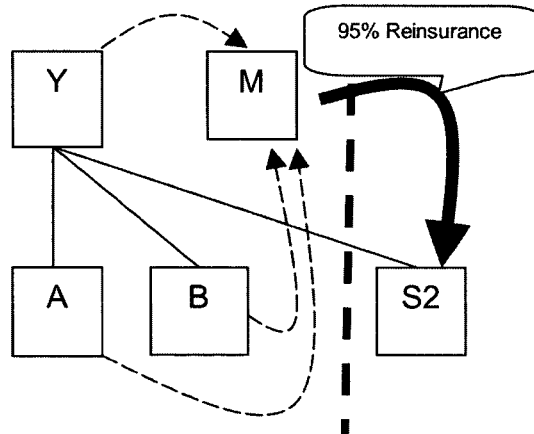
82. *See, e.g., id.*; Sedore, *supra* note 15, at 1105. Commentators note that the Service has challenged the current deductibility of premiums paid to captive insurance companies by appealing to various theories. *See, e.g.,* Sedore, *supra* note 15, at 1105-06.

83. *See* Rev. Rul. 77-316.



REV. RUL. 77-316, SITUATION 1

In *Situation 1*, X and its wholly-owned domestic subsidiaries, A and B, paid amounts to S1, a wholly-owned foreign “insurance” subsidiary of X, for various forms of property and casualty insurance. The rates paid by X, A, and B were commercially appropriate, and S1 provided insurance only to X, A, and B.

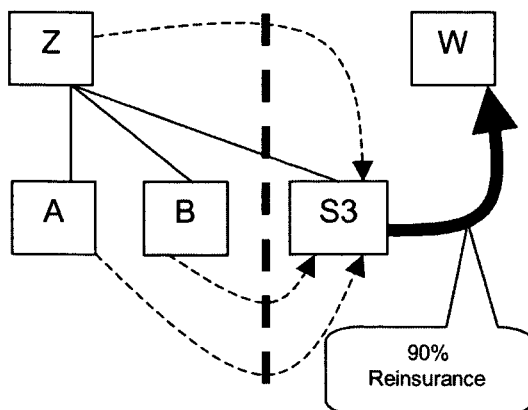


REV. RUL. 77-316, SITUATION 2

In *Situation 2*, the scenario is similar, however Y and its wholly-owned subsidiaries, A and B, paid amounts to M, an unrelated insurance company (a “fronting company”<sup>84</sup>) which, by agreement, reinsured 95% of this risk with S2, Y’s wholly-owned foreign insurance subsidiary.

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84. See Minto, *supra* note 15, at 847.



## REV. RUL. 77-316, SITUATION 3

In *Situation 3*, the facts are similar to *Situation 1*, but Z and its wholly-owned, domestic subsidiaries, A and B, paid amounts to S3, and by prior agreement, S3 reinsured 90% of this risk with W, an unrelated insurance company.

In assessing the deductibility of amounts paid from the parent company and subsidiaries to the relevant entity, Revenue Ruling 77-316 starts by emphasizing both the risk shifting/distributing standards set forth in *Le Gierse* and the historical judicial hostility directed towards taxpayer attempts to take deductions for contributions to self-insurance reserves.<sup>85</sup> The Service concluded that the amounts paid over to S1, S2, and S3 do not involve risk shifting or risk distributing because the parent company, insured subsidiaries, and captive all “represent[ed] one economic family.”<sup>86</sup> Accordingly, the Service reasoned that those suffering the loss ultimately bear the financial burden of the loss.<sup>87</sup> The Service did clarify that an arrangement constituted insurance to the extent risks were retained by third-party insurers or passed on to reinsurers (for example, the 5% retained by the fronting company in *Situation 2* and the 90% passed on in *Situation 3*).<sup>88</sup> Further, amounts paid by the purported insured subsidiaries (as premiums) and amounts paid by the captive (as loss coverage) to those subsidiaries were generally recast as dividends from one entity to the common parent followed by a contribution of a given amount to the intended recipient as a capital contribution; “premium” payments from the parent to the captive were recast as capital contributions to the captive, and loss coverage payments from the captive to the parent were deemed to be dividends to the parent.<sup>89</sup> Given that its conclusions were facially at odds with *Moline Properties, Inc. v. Com-*

85. Rev. Rul. 77-316.

86. *Id.*

87. *Id.*

88. *See id.*

89. *See id.*

*missioner*,<sup>90</sup> which dictates that an entity organized for legitimate business activity is treated as a separate taxable entity, the Service attempted to reconcile the differences. The Service emphasized that it respected the separate corporate existence of the various entities (giving due regard to their business activity), but opted to “examine[] the economic reality” presented by each hypothetical situation.<sup>91</sup>

For several years, the Service’s economic family argument managed to secure a degree of traction, especially in the U.S. Court of Appeals for the Ninth Circuit. In *Carnation Co. v. Commissioner*, the taxpayer created a wholly-owned Bermuda subsidiary to insure its risks, as well as the risks of several of its subsidiaries.<sup>92</sup> By prior arrangement, Carnation paid premiums directly to American Home Assurance Company, which proceeded to reinsure 90% of Carnation’s business with Carnation’s captive insurance subsidiary. It was clear, however, that American Home would not have entered into an agreement with the captive unless Carnation agreed to further capitalize the captive if needed.<sup>93</sup> Denying the deductibility of 90% of the premium paid to American Home, the court refused to countenance the fronting company strategy adopted by Carnation.<sup>94</sup> It also affirmatively rejected any *Moline Properties* arguments,<sup>95</sup> and thereby substantially aligned itself with the Service’s position in *Situation 2* in Rev. Rul. 77-316.

A few years later, the Ninth Circuit drove the point home in *Clougherty Packing Co. v. Commissioner*.<sup>96</sup> *Clougherty Packing* held that, even in the absence of a contingent capitalization agreement, a parent corporation’s payment of premiums to an unrelated insurer who, by pre-arrangement, reinsures that risk with a captive insurance company of the parent is not payment of an “insurance” premium because the parent “retains an economic stake in whether a covered loss occurs.”<sup>97</sup> All along, it should have been known that the outright defiance of the *Moline Properties* mandate via the economic family theory could not last.

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90. 319 U.S. 436, 438–39 (1943). (“The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or comply with the demands of creditors or to serve the creator’s personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.”).

91. Rev. Rul. 77-316.

92. *Carnation Co. v. Comm’r*, 640 F.2d 1010, 1012 (9th Cir. 1981).

93. *See id.*

94. *See id.* at 1013.

95. *Id.* (“We reject Carnation’s contention that [language quoted from Revenue Ruling 77-316] conflicts with the recognition of the separate status of corporations.”).

96. 811 F.2d 1297 (9th Cir. 1987).

97. *Id.* at 1299, 1307 (indicating that there was no indemnification, capitalization, or other guarantee in place with respect to the parent company and the wholly-owned captive insurance company).



Although the captives in *Carnation* and *Clougherty Packing* insured no one outside their affiliated group,<sup>98</sup> a number of wholly-owned or controlled insurance companies (which are technically captive insurance companies relative to their parent entities) have a substantial amount of outside business.<sup>99</sup> To conclude that such “captives” can have valid insurance relationships with non-affiliated entities, while being unable to have such relationships with affiliated entities, would defy logic and effectively gut *Moline Properties*. The Tax Court embraced this reality in *Gulf Oil Corp. v. Commissioner*.<sup>100</sup> Even though the court concluded that the percentage of insurance business from unrelated parties was insufficient,<sup>101</sup> it noted that the existence of sufficient outside business would clear the self-insurance taint of an arrangement between various affiliated entities and their captive insurance company.<sup>102</sup>

Several years later, the U.S. Court of Appeals for the Seventh Circuit adopted this view. In *Sears, Roebuck & Co. v. Commissioner*, the court held that Sears was purchasing true “insurance” from its wholly-owned subsidiary, Allstate,<sup>103</sup> because 99.75% of Allstate’s business came from other sources.<sup>104</sup> Other Courts of Appeals, as well as the Service, have since clarified that lower percentages of outside business will suffice,<sup>105</sup> but the more significant development lies in the fact that the decisions collectively establish the relative irrelevance of risk shifting in the face of substantial risk distribution. Even in the absence of a risk-shifting imperative, however, the Service could still require the existence of substantial outside business before acquiescing to the existence of a valid insurance relationship<sup>106</sup>—or so it thought.

Even before *Sears, Roebuck and Co.* and its progeny challenged the core legitimacy of a risk shifting inquiry, at least one court had begun to

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98. *Clougherty Packing Co.*, 811 F.2d at 1299; *Carnation Co.*, 640 F.2d at 1012.

99. *See, e.g., Sears, Roebuck & Co. v. Comm’r*, 972 F.2d 858, 860 (7th Cir. 1992) (noting that Allstate, a subsidiary of Sears, had substantial outside business).

100. 89 T.C. 1010, 1027–28 (1987) (concluding that the fact that the reinsuring captive insurance company had 2% net premium income from unrelated parties did not result in the characterization of “premiums” paid indirectly by the parent corporation and its affiliates as “insurance” premiums).

101. *Id.*

102. *Id.* at 1026–27.

103. 972 F.2d 858, 864 (7th Cir. 1992).

104. *Id.* at 860.

105. *See, e.g., Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135, 1152 (Fed. Cir. 1993) (holding that true “insurance” existed between a captive insurance company and the insureds in its corporate family when the captive had 44%–66% of its business coming from unrelated entities); *Amerco, Inc. v. Comm’r*, 979 F.2d 162, 168 (9th Cir. 1992) (finding sufficient unrelated business at 52%–74% of total business); *Harper Group v. Comm’r*, 979 F.2d 1341, 1342 (9th Cir. 1992) (citing unrelated business was 29%–33% percent of total business).

106. *See e.g., Gulf Oil Corp. v. Comm’r*, 89 T.C. 1010, 1027–28 (1987) (concluding that 2% of net premiums from outside sources was sufficient to create an insurance relationship between a captive and its affiliated); *see also Christopherson, supra* note 15, at 128 (pointing out that courts will look to the level of a subsidiary’s outside business in determining whether an insurance relationship exists between the parent and the subsidiary).

whittle away at the outside business requirement. In *Humana, Inc. v. Commissioner*, the U.S. Court of Appeals for the Sixth Circuit held, over the contrary opinion of the Tax Court, that risk shifting and risk distributing were present when a captive insurance company insured the risks of its brother-sister entities.<sup>107</sup> However, it did not extend to the parent-captive relationship.<sup>108</sup> The Tax Court, in considering the parent-captive relationship, concluded that the payment of a covered loss by the captive to the parent would ultimately show up on the parent's balance sheet as a reduction in the value of the captive's stock,<sup>109</sup> a result it found offensive in light of its belief that true risk shifting must occur and that "[t]rue insurance relieves the firm's balance sheet of any potential impact of the financial consequences of the insured peril."<sup>110</sup>

Although the Tax Court's logic could not apply with respect to payments for the losses of brother-sister entities of the captive, the court chose not to invite or sanction the favorable manipulation of corporate structure.<sup>111</sup> Emphasizing the *Moline Properties* mandate<sup>112</sup> and firmly rejecting the Service's economic family argument,<sup>113</sup> the Sixth Circuit opted to go a different route, respecting the balance sheet analysis with regard to the parent, but finding a valid insurance relationship between the brother-sister entities and the captive. Other courts soon followed suit.<sup>114</sup>

In addition to weathering judicial assault, the economic family theory found itself the target of scholarly criticism. One commentator charged the Service with abusing its discretion by inventing and advocating an "eccentric theory of law" to "provide a quick fix for a perceived abuse,"<sup>115</sup> rather than doing the legwork to mount an effective attack on more established grounds.<sup>116</sup> Although the commentator acknowledged

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107. 881 F.2d 247, 257 (6th Cir. 1989) (emphasizing the *Moline Properties* mandate and holding that there was risk-shifting and risk-distributing when a captive insured the risks of brother-sister entities).

108. *Id.*

109. *Humana, Inc. v. Comm'r*, 88 T.C. 197, 211-12 & n.13 (1987).

110. *Id.* at 211.

111. *Id.* at 213-14.

112. *Humana, Inc.*, 881 F.2d at 252.

113. *Id.* at 257.

114. *See, e.g., Hosp. Corp. of Am. & Subsidiaries v. Comm'r*, 74 T.C.M (CCH) 1020, 1997 WL 663283, at \*18, \*26-27 (1997) (concluding that, between a captive insurance subsidiary and its brother-sister entities, there was bona fide "insurance"); *Kidde Indus., Inc. v. United States*, 40 Fed. Cl. 42, 67 (1997) (holding that a parent company could deduct amounts paid—to cover its separately-incorporated subsidiaries—to unrelated insurer ceding amounts to parent's captive insurance subsidiary but denying such treatment with respect to payments made on behalf of the parent's divisions), *appeal dismissed per stipulation*, 194 F.3d 1330 (Fed. Cir. 1999) (unpublished table decision).

115. Singer, *supra* note 15, at 115.

116. *See id.* at 127 (arguing that the Service might have been able to attack the transactions by using § 482). Singer also notes that the Service may have had little confidence in existing precedent to support a transaction recharacterization approach. *See id.* at 123.

that taxpayers might form captives in attempts to abuse the tax system,<sup>117</sup> he went on to endorse an alternative that would have the Service focus on the captive (i.e., the income side) and require that it satisfy certain requirements in order to qualify for special treatment.<sup>118</sup>

Other commentators, like some courts, highlighted the simple inability to reconcile the economic family theory with the mandate of *Moline Properties*.<sup>119</sup> Even while noting that companies forming captive insurance companies may be motivated, to some extent, by tax considerations, they reasoned that such motivations have never sufficed to disallow premium deductions at the parent level, especially in light of the legitimate business reasons for forming captives<sup>120</sup> and the doctrine that a subsidiary be treated as a separate and distinct entity when the parent effectively establishes the subsidiary's business purpose.<sup>121</sup>

In response to the occasional irrelevance of a risk-shifting inquiry,<sup>122</sup> ready judicial acceptance of brother-sister-captive insurance relationships,<sup>123</sup> scholarly criticism,<sup>124</sup> and overt judicial rejection of the economic family argument,<sup>125</sup> the Service issued Revenue Ruling 2001-31.<sup>126</sup> In doing so, the Service promised that it would "no longer raise the 'economic family theory' set forth in Revenue Ruling 77-316 . . . in addressing whether captive insurance transactions constitute valid insurance."<sup>127</sup> The Service did emphasize that, in general, it would continue to analyze individual arrangements on a case-by-case basis and specifically challenge some arrangements, such as alleged sham transactions<sup>128</sup> and

117. *Id.* at 117.

118. *Id.* at 162-64. Singer would generally require proper record keeping and management, adequate and properly invested reserves, proper risk pooling, arms-length pricing, and maintenance of a sufficient level of unrelated policyholder business. *Id.* at 163. Singer also set forth simple disallowance of a deduction for premiums paid to a related party, but he questioned the wisdom of that approach, given the ordinariness of transferring risk to a legitimate insurance company. *Id.* at 162.

119. Knight & Knight, *supra* note 15, at 417.

120. *Id.* at 404.

121. *Id.*

122. *See, e.g.,* Sears, Roebuck & Co. v. Comm'r, 972 F.2d 858, 861 (7th Cir. 1992).

123. *See, e.g.,* Humana, Inc. v. Comm'r, 881 F.2d 247, 255 (6th Cir. 1989).

124. *See, e.g.,* Christopherson, *supra* note 15, at 128 (noting that the "economic family approach has been widely rejected"); Gomez, *supra* note 15, at 627-28 (arguing for the eradication of the economic family theory and the institution of a two-part inquiry into the legitimacy of the insurance company and the particulars of given transactions).

125. *See Humana, Inc.*, 881 F.2d at 257.

126. Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232.

127. *Id.* (internal citation omitted).

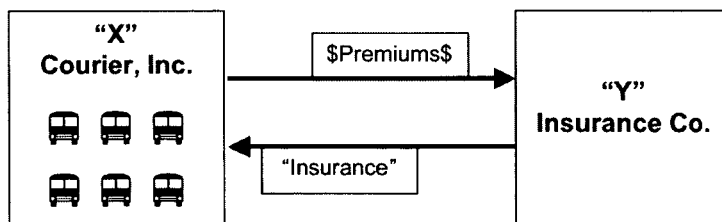
128. The Service specifically referenced *Malone & Hyde, Inc. v. Commissioner*, which held that "insurance" cannot exist between a "sham" captive and insureds in its corporate family. *Id.* (citing *Malone & Hyde, Inc. v. Comm'r*, 62 F.3d 835 (6th Cir. 1995)). According to the court, a captive will be a "sham" captive if it is either (1) undercapitalized, (2) a party to a reinsurance arrangement in which the captive's parent indemnifies the primary insurer for amounts owed by the captive to the primary insurer, or (3) both. *Malone & Hyde, Inc.*, 62 F.3d at 842-43.

purported insurance transactions between parent entities and their captives.<sup>129</sup>

### C. *The Status Quo*

Even though the Service officially abandoned its economic family argument in Revenue Ruling 2001-31, it tenaciously adheres to and applies the risk shifting/distributing standard in assessing purported insurance arrangements.<sup>130</sup> This may well be, in some contexts, a means of appealing to the economic family theory under a safer rubric. Indeed, recent IRS pronouncements demonstrate that the Service has already taken the entire game to the next level. Rather than merely assessing the existence of an insurance relationship when the transaction involves affiliated entities, the Service is now willing to scrutinize transactions between purported insureds and entities *wholly unaffiliated* with the insured or its group (even when there is no reinsurance with a controlled subsidiary of the insureds). Arguably, this move represents the opening salvo of a new wave of intent: the elevation of form over substance in the captive arena.

In Revenue Ruling 2005-40,<sup>131</sup> the Service presented and assessed four situations to clarify its current litigating position. Each situation is presented schematically with the Service's assessment appearing immediately thereafter. All situations involve a domestic entity, X, which operates a courier transport business, owns a substantial fleet of automotive vehicles, needs to insure those vehicles against various operational risks, and pays an arm's length premium to Y for the coverage. Note that in each instance, X owns vehicles "representing a significant volume of independent, homogenous risks"<sup>132</sup> (that is, enough to distribute risk independently), and that Y is adequately capitalized and operates in accord with state law.<sup>133</sup>



REV. RUL. 2005-40, SITUATION 1

129. See, e.g., *Clougherty Packing Co. v. Comm'r*, 811 F.2d 1297, 1307 (9th Cir. 1987) (holding that a parent–subsidiary transaction was not insurance).

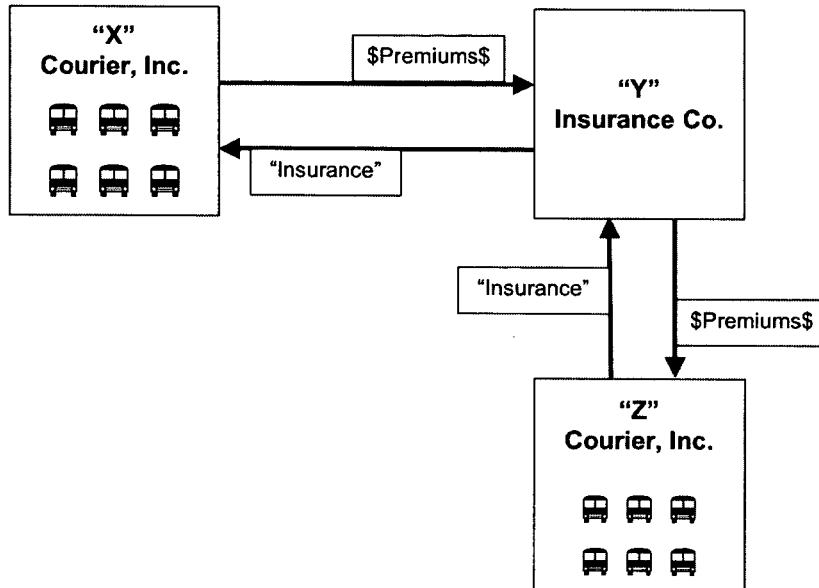
130. Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946; Rev. Rul. 2005-40, 2005-2 C.B. 4, 2005 WL 1415557.

131. Rev. Rul. 2005-40.

132. *Id.*

133. *Id.*

In *Situation 1*, the X–Y contract constitutes 100% of Y’s business. The Service acknowledges that X shifted risk from itself to Y, but, after noting that Y does not insure any non-X risks, concludes that Y has not distributed X risks amongst other policyholders. Accordingly, the Service concludes that the relationship between X and Y is not an insurance relationship.<sup>134</sup>

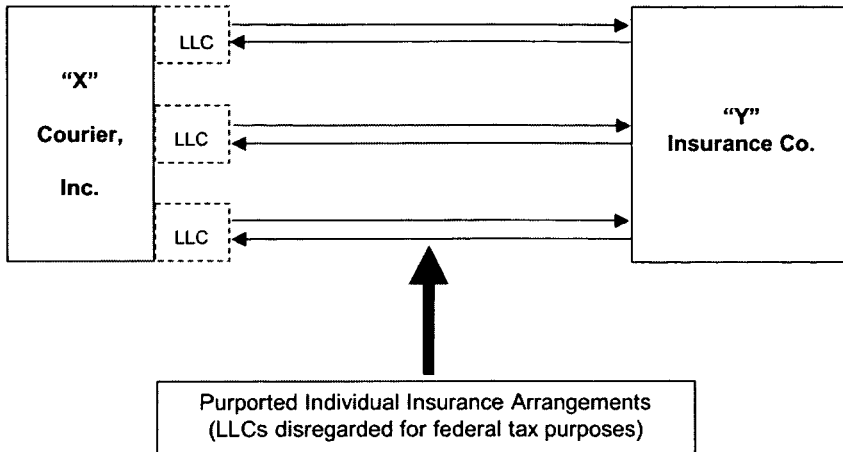


REV. RUL. 2005-40, SITUATION 2

The facts in *Situation 2* indicate that the X–Y contract constitutes 90% of Y’s business and that the remaining 10% comes from Y’s contract with Z. Here too, the Service concludes that the relationship between X and Y is not an insurance relationship. Although Y’s relationship with Z adds some degree of risk distribution, the Service concludes that the 10% of risk from Z is insufficient to alter the character of the X–Y relationship.<sup>135</sup> Therefore, the relationship does not constitute “insurance.”

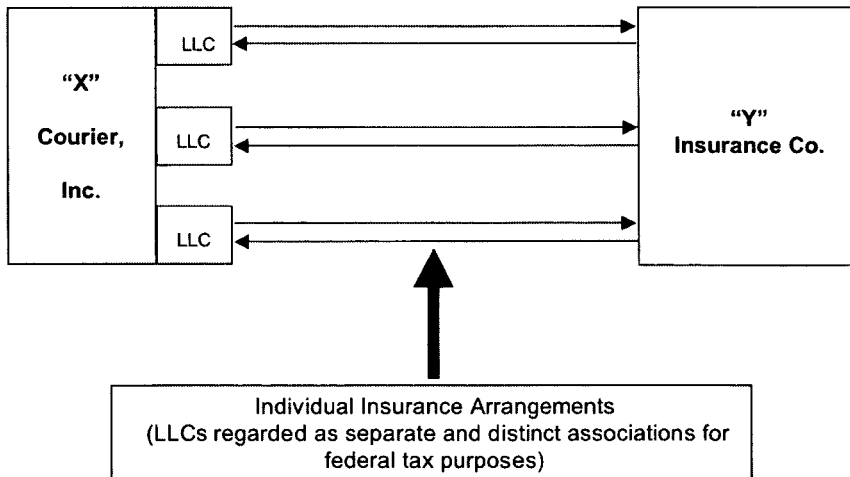
134. *Id.*

135. *Id.*



## REV. RUL. 2005- 40, SITUATION 3

In *Situation 3*, Y does not contract with X. Instead, Y contracts with twelve LLCs, each of which has X as its single member. X conducts its business through the LLCs, and each LLC has elected to be disregarded for federal income tax purposes (that is, each LLC has elected not to be treated as separate and distinct from X). The facts also indicate that each contract between Y and a disregarded LLC constitutes 5%–15% of Y's total business and that Y insures no other entities. Because Y is treated as contracting only with X, the Service concludes that the individual arrangements do not constitute insurance for the same reasons set forth in *Situation 1*.<sup>136</sup>



## REV. RUL. 2005 - 40, SITUATION 4

*Situation 4* is the same as *Situation 3*, except that the LLCs elect to be treated as entities separate and distinct from X. Under these facts, the

Service concludes that the individual LLCs shift risk to Y and that the risk is distributed amongst the twelve LLCs. Accordingly, the relationships are deemed to constitute “insurance” relationships.<sup>137</sup>

The Service’s most recent pronouncement in the captive insurance arena is Revenue Ruling 2008-08,<sup>138</sup> which involves a sponsored captive in the form of a “protected cell company.”<sup>139</sup> A protected cell company is similar, in many ways, to a group captive, an arrangement in which various companies come together and form a captive for the purpose of insuring their own risks.<sup>140</sup> The Service has ruled that premium payments to a group captive owned by thirty-one companies were “insurance” premiums,<sup>141</sup> noting that “because the taxpayer and the other insureds-shareholders are not economically related, the economic risk of loss can be shifted and distributed among the shareholders who comprise the insured group.”<sup>142</sup> A protected cell company differs from a group captive in that separate cells/accounts are created for each equity holder making a capital contribution, and each cell receives premiums and insures the risks of the designated equity holder.<sup>143</sup> Revenue Ruling 2008-08 clarifies that insurance may or may not exist with respect to a given protected cell company relationship.

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137. *Id.*

138. Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946.

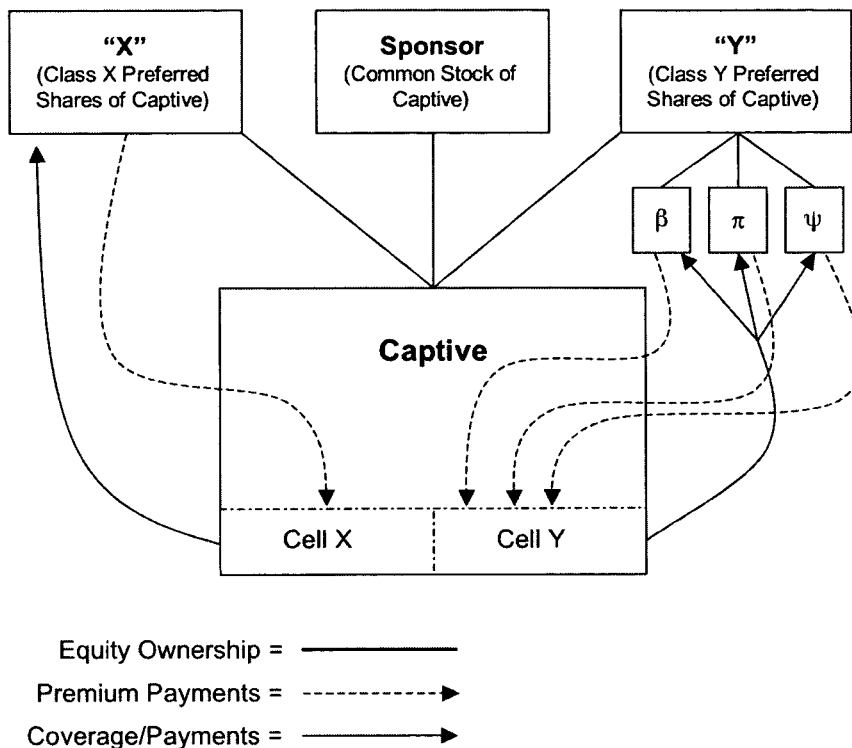
139. *Id.*

140. See Minto, *supra* note 15, at 842.

141. Rev. Rul. 78-338, 1978-2 C.B. 107, 1978 WL 41909 (concluding that premium payments made to a group captive owned by 31 companies were ordinary and necessary business expenses—i.e., “insurance” premiums).

142. *Id.*

143. Gantt, *supra* note 15, at 520 (“With the protected cell, investor funds are not subject to losses affecting other parts of an insurance company. Monies from investors would be deposited into a protected cell and used for a specific delineated purpose, such as catastrophic loss.”).



## REV. RUL. 2008-08

In this protected cell company arrangement, X only pays premiums to Cell X, and Cell X only insures the risks (and pays the losses) of X.<sup>144</sup> Similarly, Cell Y only receives payments from  $\beta$ ,  $\pi$ , and  $\psi$  and only insures the risks (and pays the losses) of those entities.<sup>145</sup> The Service concluded that the arrangement between Cell X and X does not constitute an insurance arrangement because the relationship is akin to one in which a subsidiary insures only its parent.<sup>146</sup> Accordingly, risk shifting and risk distributing are not present; thus, no insurance relationship exists.<sup>147</sup> Noting that the relationship between Cell Y and the wholly-owned subsidiaries of Y were akin to a brother-sister insurance relationship, the Service concluded that the arrangements constituted insurance given the presence of adequate risk shifting and risk distributing.<sup>148</sup>

## III. CRITIQUE

Although the Service officially asserted that it would no longer employ the “economic family” argument in assessing captive insurance

144. Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*



company arrangements,<sup>149</sup> recent IRS pronouncements demonstrate it did not tell the whole truth. The prevailing common law environment will not allow an economic family argument to succeed in a captive-brother-sister setting.<sup>150</sup> But, depending on the level of non-parent business at the subsidiary level, the Service can still get away with it in some parent-captive contexts (or those deemed akin to that context) so long as the position is cloaked in the garb of risk shifting and risk distributing.<sup>151</sup> Assuming *arguendo* that the risk shifting and risk distributing standards were ever truly useful, they now arguably fall short as effective determinants, especially in today's complex business environment.

#### A. The Shell of Risk Shifting

*Sears, Roebuck & Co.* and its progeny have firmly established that an insurance relationship exists between a parent company and its wholly-owned subsidiary when the subsidiary has a sufficient level of outside business.<sup>152</sup> Thus, although the Service routinely cites *Le Gierse* on the way to its risk shifting and risk distributing analyses,<sup>153</sup> various courts (whether explicitly or implicitly) fail to regard risk shifting, in the traditionally-understood sense, as a *sine qua non* of insurance.<sup>154</sup> To the extent a sufficient level of risk distribution is the key to eliminating the risk shifting requirement, established companies with substantial outside business enjoy an undue benefit relative to new and growing companies.

Although a given company may, after further development, reap the same benefits, there remains the troubling problem of uni-directionality. Under *Sears, Roebuck & Co.*, an insurance relationship is deemed to exist between a parent company and its wholly-owned captive insurance subsidiary because the captive has a sufficient level of outside business to distribute its risks adequately (in other words, because the *captive* has enough homogenous, independent risks to satisfy the law of large numbers).<sup>155</sup> This reality does not change when the parent company adds its risks to the mix, but, per the confirmation of Revenue Ruling 2008-08, the street only runs one way.<sup>156</sup> If it is the *parent* (or a parent-like entity) with enough homogenous, independent risks to satisfy the law of large numbers, the Service will not respect the parent-captive arrangement as

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149. Rev. Rul. 2001-31, 2001-1 C.B. 1348, 2001 WL 606232.

150. See, e.g., *Humana, Inc. v. Comm'r*, 881 F.2d 247, 248-52 (6th Cir. 1989).

151. See, e.g., *Hosp. Corp. of Am. & Subsidiaries v. Comm'r*, 74 T.C.M. (CCH) 1020, 1997 WL 663283, at \*24-\*26 (1997); *Kidde Indus., Inc. v. United States*, 40 Fed. Cl. 42, 51-57 (1997), *appeal dismissed per stipulation*, 194 F.3d 1330 (Fed. Cir. 1999) (unpublished table decision).

152. See, e.g., cases cited *supra* note 61.

153. See, e.g., Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946.

154. See, e.g., *Humana, Inc.*, 881 F.2d at 252-56.

155. *Sears, Roebuck & Co. v. Comm'r*, 972 F.2d 858, 860 (7th Cir. 1992) (noting that Allstate collects more than \$5 billion in premiums annually and that "[s]ome 99.75% of Allstate's premiums [come] from customers other than Sears").

156. Rev. Rul. 2008-08 (citing Rev. Rul. 2005-40, 2005-2 C.B. 4, 2005 WL 1415557; Rev. Rul. 2002-89, 2002-2 C.B. 984, 2002 WL 31749579) (indicating that the relationship between X and Cell X would not qualify as insurance).

"insurance" in the absence of outside business at the captive level, because risk shifting and risk distribution are deemed absent.<sup>157</sup> That is, the Service would refuse to find "insurance" despite the presence of effective risk distribution and arguable irrelevance of the risk shifting standard. A far more egregious problem arises when the Service elects to ignore risk-distributing realities in a similar context: when a *non-affiliated* insurer is involved and risk shifting cannot be denied.

*B. The Husk of Risk Distribution: Doctrinal Issues*

Under Revenue Ruling 2005-40, *Situation 1*, the Service will not respect an arrangement as insurance where a single entity with risk distributing capacity happens to be the only insured with respect to an *unrelated* entity.<sup>158</sup> Arguably, this approach represents an aggressive elevation of form over substance. X's homogenous, independent risk units are lumped together under a single corporate roof<sup>159</sup> such that, for risk distribution purposes, X is deemed to be nothing more than a single insured corporate entity.<sup>160</sup> And while the Service appears to acknowledge the existence of risk shifting,<sup>161</sup> its final conclusion on *Situation 1* reveals something altogether suspect. Rather than recognizing the business reality (that Y is insuring a large volume of homogenous, independent risks such as individual vehicles), the Service deems Y's business activity to be the attempt to insure one entity, X, even though Y, by contract, would likely have been on the hook with respect to an individual vehicle loss, and not solely on the loss of the entire fleet. The Service's posture in this regard is perplexing in light of the Tax Court's conclusion in *Gulf Oil Corp. v. Commissioner* that "a single insured can have sufficient unrelated risks to achieve adequate risk distribution,"<sup>162</sup> and the IRS's pronouncement indicating that "a single taxpayer may transfer an amount of homogenous and statistically independent risks which would be sufficient to satisfy the risk distribution requirement."<sup>163</sup>

The question then becomes whether it is appropriate to pierce the veil of the nominal insured for risk distribution assessment purposes.<sup>164</sup> Surprisingly, as discussed below, the Service willingly confirmed in at least one instance that individual independent risk exposures are meas-

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157. *Compare* Rev. Rul. 2008-08 (finding that no insurance relationship existed in a given transaction because it was akin to a parent-subsidiary relationship), *with* *Sears, Roebuck & Co.*, 972 F.2d at 860 (7th Cir. 1992) (finding that insurance existed when a subsidiary with substantial outside business insured its parent).

158. Rev. Rul. 2005-40, 2005-2 C.B. 4, 2005 WL 1415557.

159. *Id.*

160. *Id.*

161. *See id.*

162. *Gulf Oil Corp. v. Comm'r*, 89 T.C. (CCH) 1010, 1026 (1997).

163. I.R.S. Field Serv. Adv. (Oct. 19, 1998), 1998 WL 34066011.

164. Logic and experience dictate that when an insurance company issues a group life insurance policy, there is no confusing insured individuals with the common corporate employer.

ured by looking *within* the corporate entity,<sup>165</sup> not by viewing the corporate entity as a single insured unit.

In Private Letter Ruling 9624028, the Service addressed the deductibility of amounts paid by thirty-six Funds to an assessable mutual insurance company owned solely by the thirty-six Funds and formed to insure them against various loss events with respect to the investments made by each Fund.<sup>166</sup> After highlighting the fact that none of the Funds owned a controlling interest in the mutual,<sup>167</sup> the Service noted the following:

[I]n terms of risk distribution, we note that Mutual has accepted a large number of independent risks and is taking advantage of the “law of large numbers.” (The (independent) risk exposures here are possible defaults of *any one* of the 28x issues of “securities” of Fund 1 (or the possible default of any of the issues of any other of the 35 funds).)<sup>168</sup>

Thus, the Service privately says that it will look beyond the corporate shell at individual risk units to ascertain whether risk has been adequately distributed, but pronounces something altogether different in *Situation 1* of Revenue Ruling 2005-40. The analytical consistency does not improve with *Situations 2–4* of that pronouncement.

In *Situation 2*, the Service concludes that the presence of an additional business source does not automatically alter the character of the X-Y relationship.<sup>169</sup> However, to the extent that this ruling and others designate or look to a specific percentage of outside business as key to the “insurance” analysis, they reveal nothing more than arbitrary line-drawing. The Service’s conclusions regarding *Situations 3* and *4*, viewed together, would appear to allow, rather inexplicably,<sup>170</sup> a taxpayer to create or destroy “insurance” merely by making an election.<sup>171</sup> Yet, random elevations of form over substance have been prohibited in this arena since Edyth Le Gierse struck her deal with Connecticut General. Or at least that’s been the long-running story.

### C. *The Husk of Risk Distribution: The Modern “Insurance” Reality*

Wholly aside from doctrinal problems, practical realities do not jibe well with the Service’s prevailing risk distribution standard. The canvas of background assumptions is too pristine. Although it may be comfort-

165. I.R.S. Priv. Ltr. Rul. 96-24-028 (June 14, 1996), 1996 WL 326435.

166. *Id.*

167. *Id.*

168. *Id.* (emphasis added).

169. Rev. Rul. 2005-40, 2005-2 C.B. 4, 2005 WL 1415557.

170. See Sedore, *supra* note 15, at 1104 (describing the Service’s rationale in assessing *Situations 3* and *4* as “somewhat inexplicable” because in some instances, the Service respects the separate existence of disregarded LLCs).

171. See *id.*

ing to assume that insurance companies willingly offer life, health, and other forms of insurance to broad segments of the population and quietly allow the law of large numbers to operate, the truth is far nastier.

Modern insurance is a business more so than ever, and rather than suffer the vagaries of the law of large numbers, underwriters do their best to outsmart or outmaneuver it. Companies impose tough underwriting standards and thereby manage to issue unwarranted denials of coverage. And even when coverage is offered and premiums are paid over time in good faith, companies habitually attempt to deny coverage by appealing to, among other things, contractual exclusions for "pre-existing conditions" and "experimental" treatments.<sup>172</sup>

The case of Patrick Tumulty is typical. After paying health insurance premiums to Assurant Health for six years (under a series of six-month policies),<sup>173</sup> the company ultimately refused coverage for Tumulty's kidney disease.<sup>174</sup> Because the company treated him as a new insured under each contract,<sup>175</sup> his ailment was deemed a pre-existing condition when it was finally diagnosed<sup>176</sup>—prior medical tests under "prior" policies proved it.<sup>177</sup>

If certain commentators are to be believed, the problem of unwarranted coverage denial is rampant. In his searing documentary on the American health care system,<sup>178</sup> Michael Moore captured the prevailing sentiment. One claims adjuster noted, "[People aren't] slipping through the cracks, . . . [The insurance companies] made the crack and are sweeping you toward it."<sup>179</sup> Thus, at least with respect to some forms of insurance, the theoretical operation of risk distribution stands in stark contrast to practical realities.

Further, at the same time that companies are attempting to minimize or eliminate the negative impact of the law of large numbers in one sphere, they are also flouting, misinterpreting, or simply ignoring the fundamental rules of traditional risk distribution elsewhere. As the following discussion demonstrates, the AIG saga adds an exclamation point to that assertion and helps reveal the truly limited utility of the risk distribution standard, as currently applied as an "insurance" determinant.

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172. See Karen Tumulty, *The Health Care Crisis Hits Home*, TIME, Mar. 16, 2009, at 26, available at 2009 WLNR 4231105 (discussing the misfortune of Patrick Tumulty whose kidney disease was deemed to be a non-covered, pre-existing condition by Assurant Health, which issued him a series of six-month policies and treated him as a new insured under each contract).

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.*

178. STCKO (Weinstein Company 2007).

179. Richard Corliss, *Sicko Is Socko*, TIME.COM, May 19, 2007, <http://www.time.com/time/arts/article/0,8599,1623337,00.html>.

As noted earlier, risk distribution relies on the operation of the law of large numbers. With a sufficiently large pool of individuals, for example, actual mortality and predicted mortality will roughly correspond due to the accuracy of historical mortality and morbidity data. Thus, the law of large numbers operates well in some insurance environments (such as life insurance). If, however, a company seeks to insure against the occurrence of an event when there is no reliable data with respect to prior events, accurate probabilities cannot be ascertained, and the law of large numbers (no matter how large the pool of insureds) cannot be relied on to match predicted and actual experience going forward.<sup>180</sup> As explained below, AIG's treacherous dalliance with credit default swaps and special purpose vehicles bears this out.

#### *D. Special Purpose Vehicles, Credit Default Swaps, and Sub-Prime Mortgages*

Several years ago, there was a sharp and noticeable uptick in the making of subprime loans.<sup>181</sup> Certain existing and aspiring homeowners were easy targets.<sup>182</sup> Once originated, the individual mortgage obligations were transferred through the hands of various industry participants, and ultimately pooled together in a trust or other entity—such as a special purpose vehicle or “SPV”<sup>183</sup>—such that interested parties could invest in the pool by purchasing debt securities of the SPV from the trustor/seller.<sup>184</sup> In general, these securities were issued in tiers or tranches which were rated by various credit rating agencies, like Standard & Poor's, according to the likelihood that the holder would be paid (e.g., from “AAA” to “BBB” and below).<sup>185</sup> Before parting with higher ratings for senior investment grade securities, however, rating agencies would commonly require the SPV to obtain some form of credit enhancement, such as a guarantee, to ensure that payment shortfalls with respect to those securities would be covered.<sup>186</sup> For these senior tiers of debt, many SPVs looked to insurance companies to provide the requisite payment guarantee.<sup>187</sup>

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180. See Taylor, *supra* note 15, at 878–82.

181. Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 571 (2002).

182. See *id.* at 572.

183. *Id.* at 538–39.

184. *Id.* at 539.

185. *Id.* at 540–41; Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2047 (2007).

186. Engel & McCoy, *supra* note 185, at 2047.

187. See Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2210 (2007).

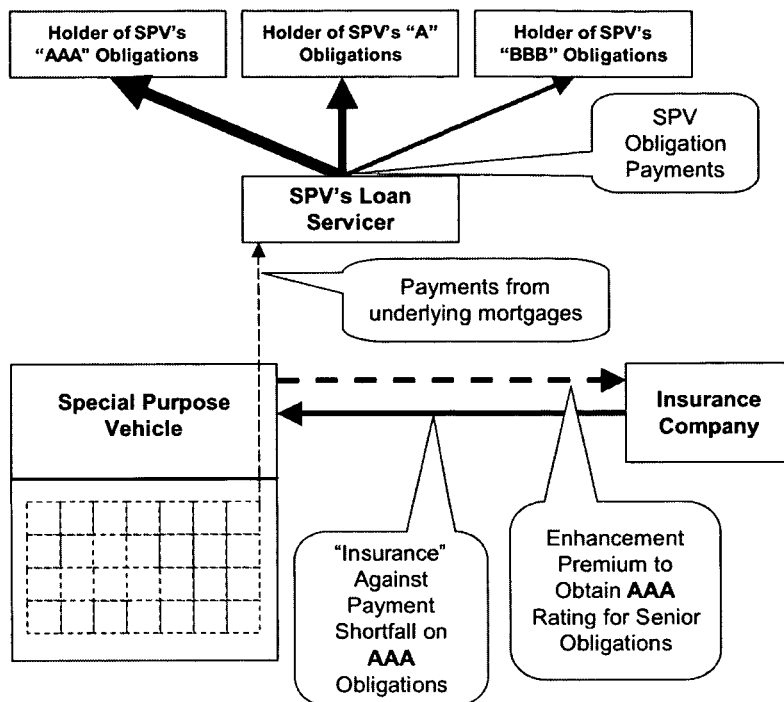


FIGURE 1: SPECIAL PURPOSE VEHICLES

At the same time, at the other end of the equation, financial institutions holding sub-prime, mortgage-backed debt obligations or some re-packaged derivative thereof—such as a “collateralized debt obligation,” or “CDO”<sup>188</sup>—would contract with counterparties to insure against default.<sup>189</sup> AIG Financial Products Corporation (“AIGFP”), a subsidiary of AIG, was one such counterparty.<sup>190</sup> AIGFP issued this form of “debt insurance”<sup>191</sup>—referred to as a “credit default swap,” or “CDS”—even though it was organized as a bank and not an insurance company.<sup>192</sup> Though the CDS business generated hundreds of millions of dollars of insurance premium income when times were good,<sup>193</sup> the lurking obligations ultimately put AIG on the hook for various obligations under the CDOs.

188. Gretchen Morgenson, *Behind Biggest Insurer's Crisis, A Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1, available at 2008 WLNR 18427841.

189. *Id.*

190. *Id.*

191. See Saporito, *supra* note 30, at 24 (“[A] CDS is, in its simplest form, an insurance policy . . . AIG wrote multiple insurance policies covering the same underlying package of increasingly toxic assets.”).

192. *Id.*; Henny Sender, *AIG Still Facing Huge Credit Losses*, FIN. TIMES, Mar. 4, 2009, at 1 (“AIG was particularly active in providing guarantees for . . . collateralised debt obligations, bonds backed by debts such as subprime mortgages.”).

193. Morgenson, *supra* note 188, at A1 (indicating that the CDS business was generating as much as \$250 million in premium income).

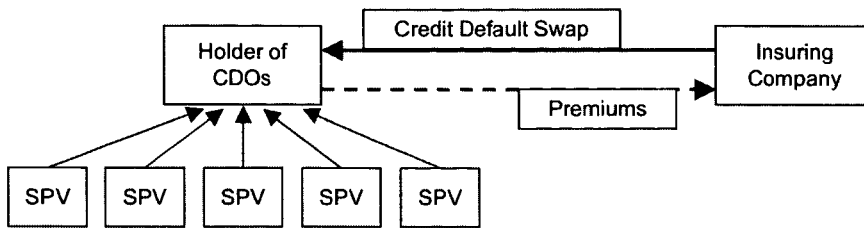


FIGURE 2: CREDIT DEFAULT SWAPS

With CDO stability ultimately depending on payment streams from holders of sub-prime mortgages and on rising home values, it did not take long for the disaster that was waiting in the wings to step in when the housing bubble burst.

From a pure insurance theory perspective, the problem is clear. Even with a large number of SPVs and an even larger pool of independent debt obligations insured against default, the law of large numbers can operate successfully only if the insurance issuer has reliable probability data with respect to the event insured against (i.e., default with respect to the obligation held).<sup>194</sup> Large numbers matter because such numbers generally make actuarial predictions meaningful.<sup>195</sup> Regarding pool size in this context, one commentator notes the following:

[A]lthough credit derivatives may transfer insurance risk, an investor who assumes this risk does not usually assume the risks of a sufficiently large number of underlying obligors so as to pool and dilute (or diversify) the risks in any statistically meaningful sense. As a result, these investors do not satisfy the pooling condition for insurance and the contract should not constitute insurance for the credit protector or, under conventional wisdom, for the credit protected counterparty.<sup>196</sup>

The news gets worse from a probability data perspective. It might have been the case that historical mortgage default information was readily available and could have provided predictive value with respect to non-sub-prime mortgages. The same certainly cannot be said with respect to obligations backed by pooled sub-prime mortgages. Securitization of sub-prime mortgages is relatively new, and *a priori* probabilities do not exist with respect to the likelihood that this particular type of CDO will default. Acquiring a reliable default probability would have required an extensive assessment of the prior performance of similarly-backed CDOs, but at the time the “insurance” was issued, that information did not exist. According to at least one commentator, industry participants were, nonetheless, blindly undaunted:

194. See Taylor, *supra* note 15, at 877–83.

195. See Singer, *supra* note 15, at 116.

196. David S. Miller, *Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace*, 55 TAX LAW. 481, 542 (2002).

Financiers, as well as the investors who bought their wares and the ratings agencies that evaluated them, agreed that by applying the proper equations it was possible to, say, bundle a bunch of subprime mortgages, chop them up and sell the pieces as fairly safe securities, even as they were leveraged to the hilt. Why? The mathematical models—backward-looking and based on just a few years' data from an asset bubble—said so.<sup>197</sup>

As it turns out, short-term experience proved negative for AIGFP, and, for the sake of the larger financial sector: AIG, the parent company ultimately liable, had to be rescued. To the extent that the prevailing "risk distribution" assessment is based on the mere existence of a large number of risk units in the insured pool, without any real effort to ascertain whether reliable risk-occurrence probabilities exist for that pool, the standard lacks real teeth and thus creates the appearance of insurance where none truly exists.<sup>198</sup> Indeed, investment activity can masquerade as "insurance." Ben Bernanke, Chairman of the Federal Reserve, hit the nail on the head when he referred to AIGFP as "a hedge fund basically that was attached to a large and stable insurance company."<sup>199</sup>

And that is not the worst of it from a federal tax perspective. Wholly aside from facts specific to AIGFP and AIG, if a given company's investment activities can mask as "insurance" (a likelihood enhanced by the proximity of legitimate insurance and the expectation of some investment activity), then a company may undeservedly qualify as an insurance company by appearing—to the naked eye—to satisfy the "more than half" standard. And even if a company satisfies the "more than half" standard, notwithstanding the masquerading of investment activity as insurance (because of the extent of its pure insurance business), the company nonetheless may understate its income by overstating its unearned premiums and/or unpaid loss reserves.

Although the Service tenaciously adheres to standards and concepts articulated in the 1940s to ascertain whether a given arrangement rises to the level of "insurance,"<sup>200</sup> modern courts have not hesitated to question

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197. Barbara Kiviat, *Reassessing Risk*, TIME, Nov. 17, 2008, at 1, available at 2008 WLNR 21138582.

198. In discussing the concept of insurance for purposes of the McCarran-Ferguson Act, one commentator makes a similar point. See Steven J. Williams, Note, *Distinguishing "Insurance" from Investment Products under the McCarran-Ferguson Act: Crafting a Rule of Decision*, 98 COLUM. L. REV. 1996 (1998) (noting that the securitization process itself may appear to shift risk from one lender to another who pools and thereby distributes risk but does not, itself, constitute "insurance"). Highlighting the weakening of the line between banking and insurance, the author notes that "financial services innovation and expanding national bank powers have blurred the line between bank-authorized investment products and insurance." *Id.* at 1996. The author further points out that "a judicial definition of 'insurance' which only looks for some element of risk, without determining whether that risk is of the kind commonly associated 'insurance,' will inevitably reach beyond any common understanding of the term." *Id.* at 2019.

199. Sender, *supra* note 192, at 1.

200. See Rev. Rul. 2008-08, 2008-1 C.B. 340, 2008 WL 131946 (citing *Helvering v. Le Gierse*, 312 U.S. 531 (1941)).



the relevance of a risk-shifting inquiry.<sup>201</sup> In doing so, they rob that prong of the analysis of its evaluative force more generally. Further, even though there are those who embrace risk distribution as the true essence of insurance,<sup>202</sup> scholars compellingly argue that the law of large numbers has predictive value only when attached to reliable probability data,<sup>203</sup> a point which is occasionally lost on, ignored, or suppressed by modern-day insurers. Additionally, the law of large numbers does not appear to be a *sine qua non* of a risk distribution finding by the Service. It also bears noting that, in some contexts, adequate risk distribution is the only hurdle to clear. One commentator summarizes the problem well:

One of the consequences of reliance on *Le Gierse* is that instead of developing analyses of pooling, homogeneity, independence and volume, advocates of both the economic family and recharacterization approaches are left with the bare words "risk distribution," which mean nothing without further explanation and contextualization. This problem was exacerbated in subsequent years when even the advocates of the recharacterization approach appeared to reduce the issue of defining an insurance operation to a computation of the amount of unrelated risks covered by the captive.<sup>204</sup>

Wholly aside from problems with the theoretical underpinnings of risk shifting and the limited utility of current risk distribution assessments, one can argue that both the two-test hurdle and the longstanding hostility towards deductions for self-reserving activity have resulted in an unhealthy concentration of risk (both predictable and dangerously unpredictable) in large, long-established entities that still qualify as "insurance companies," even though a hefty chunk of their business constitutes pure investment activity.

Shifting risk to an insurance company and having that risk distributed at the insurance company level may make good business sense for certain companies in certain industries. However, in viewing the universe of insurable risks more broadly, there is certainly room to consider approaches that promise better checks on risk concentration and thus, a more effective balancing of traditional risk shifting/distributing and rational risk retention.

#### IV. PROPOSALS

Scholars have proposed various solutions to the captive insurance company problem, such as focusing on the treatment of the captive and requiring the captive to satisfy certain requirements in order for it to

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201. See, e.g., *Sears, Roebuck & Co. v. Comm'r*, 972 F.2d 858, 863-64 (7th Cir. 1992).

202. See Note, *supra* note 19, at 784 (emphasizing that "[t]he process of risk distribution . . . is the very essence of insurance").

203. Taylor, *supra* note 15, at 878-83.

204. Singer, *supra* note 15, at 140.

qualify for special treatment—for example, proper risk-pooling, arms-length pricing, and maintenance of a sufficient level of unrelated policyholder business.<sup>205</sup> Fortunately, and perhaps due to a degree of judicial arm-twisting, some of those solutions are reflected in existing law. One approach, for example, respects the captive arrangement if there exists sufficient outside business at the captive level.<sup>206</sup> Others see the solution as a simple matter of weighing the business purpose of establishing the captive against any apparent tax avoidance purposes.<sup>207</sup> Neither approach is wholly satisfactory. The former fails to fully embrace the notion that one company may have a sufficient volume of homogenous risk and should have self-insuring options available without the participation of an external, unrelated third-party insurer. The latter approach is encouraging but could benefit from the imposition of specific standards to ensure that self-insuring is truly feasible, and not merely a matter of sufficiently weighty business purpose.

Thus, along those lines, the following discussion proposes contextual self-insuring. To address the problem of concentrated risk and to advance a simple utilitarian goal, this Article proposes the allowance of current deductions for the creation of limited contingency reserves for a specific subset of taxpayers.

#### *A. Contextual Self-Insuring*

The contextual self-insuring model seeks, at root, to allow companies with certain risks to self-insure through a related entity and deduct the relevant “premiums,” even if the arrangement would not satisfy the Service’s traditional risk shifting/distributing standard (such as a parent–subsidiary arrangement). A company would qualify for contextual self-insuring only if it could satisfy each of the following requirements:

- (1) The arrangement involves an insurance risk and not merely an investment risk;
- (2) Either the company finds a captive arrangement financially appealing *or* the desired insurance is commercially unavailable, available only at an exorbitant cost, or available at a cost substantially higher than the amount the company would have to pay if self-insuring;

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205. See, e.g., *id.* at 162–164.

206. See, e.g., *Sears, Roebuck & Co.*, 972 F.2d at 863–64.

207. Winslow, *supra* note 15, at 135 (arguing that captive insurance arrangements should be analyzed by weighing legitimate business purposes against tax avoidance purposes, rather than attempting to ascertain whether insurance is “theoretically present”). Winslow has the same view with respect to retrospectively rated insurance contracts. See Donald Arthur Winslow, *A Note on Retrospectively Rated Insurance and Federal Income Taxation*, 79 KY. L.J. 195, 221–23 (1990) (suggesting that a business purpose test might be a more useful means of ascertaining whether insurance exists in a retrospectively rated contract). He notes that a retrospective insurance arrangement allows an insurance company to share the cash flow advantages typical of self-insurance or captive insurance company arrangements. See *id.* at 197.

- (3) The taxpayer has a sufficient number of homogenous, independent risk units;
- (4) There exists sufficient, reliable historical information regarding the risk pool such that the law of large numbers can operate effectively; and
- (5) The insuring entity will be adequately capitalized and operated in accordance with the law of the captive's jurisdiction.

Companies unable to satisfy the foregoing would have the option of forming a group captive or going the traditional route and seeking coverage from an insurance company in an arrangement currently sanctioned by existing law. The proposal effectively allows individual companies that are able to distribute their own risks internally to avoid the high cost of obtaining that insurance from a third party, an alternative that is particularly appealing if the company is required to obtain the coverage. Further, this approach allows those same companies to access reinsurance markets directly, to the extent they feel reinsuring is appropriate, and avoids many potential problems that might be encountered when dealing with a third-party insurance company (such as resistance to claim payment and unnecessary delay).

Contextual self-insuring is, of course, vulnerable to the argument that allowing some companies to take deductions for self-insuring allows distortion and substantial understatement of income, a result that is unfair to other companies lacking the business profile or sheer size which would allow them to take advantage of this elaborate form of contingency reserving. There is also the potential charge that the eligibility standards are weighed down by ambiguities, such as: What qualifies as "exorbitant cost," when does a higher cost become "substantially higher," and what qualifies as "reliable historical information?"

Fortunately, current and historical market data can point those in a position to apply the standards in the right direction. Prevailing market rates can easily sort out "exorbitant" costs, and neutral decision-makers can readily assess the extent and quality of probability data to ascertain whether it is reliable and useful in the relevant context. That being said, a limited amount of ambiguity should not be fatal; applicable standards should allow some degree of flexibility and room for healthy evolution while, at the same time, retaining their immunity from easy manipulation. To the extent that there are legitimate fears regarding income distortion, there are a host of options with respect to reducing or minimizing the apparent harm. For example, allowing deduction of only a percentage of the premium, phasing in a full or partial deduction over a given time period, and disallowing a premium deduction altogether once the insuring company attains a certain financial profile.

While it remains true that only some companies will qualify for contextual self-insuring, society cannot deny the differential treatment of

various corporate taxpayers under current law, and should weigh the harm inadvertently suffered by individual companies against the overall health of the business sector and dangers of concentrated risk. Small companies, no matter how limited their product or service line, have insurable risks. Thus, to the extent these companies choose to grow and expand, they too may ultimately attain that critical mass of independent risk units which would allow them to take advantage of contextual self-insuring.

### *B. Utilitarian Contingency Reserving*

The notion of utilitarian contingency reserving proposed here consciously departs from any consideration of risk shifting, risk distributing, or traditional notions of insurance. Rather, the core idea is that companies of a certain size—or those operating in certain industries—should, as a matter of sound tax policy, and in accord with pursuit of the common good, be allowed to establish and take deductions for contributions to a limited contingency reserve.

What industries and company sizes qualify? The question is tough to answer but obviously depends on the extent lawmakers wish to make available deductions for reserving. Whether broadly or narrowly tailored, if a utilitarian justification is to have force, a qualifying company must either be large enough such that a failure of the company or a sudden financial challenge to it would negatively affect a substantial segment of the U.S. economy (i.e., “too big to fail”), or be engaged in an industry in which the ready availability of capital in an emergency (or even over the long haul for crucial non-emergency activities) would maximize the health, safety, and welfare of the citizenry, such as clean-up immediately after an environmental disaster.

In any event, federally-endorsed reserving outside the insurance arena is not a revolutionary notion. Since 1984, taxpayers operating nuclear power plants have been able to take deductions for contributions to a Nuclear Decommissioning Reserve Fund (“NDRF” or “Fund”),<sup>208</sup> and the tax rules and procedures governing NDRFs serve as an excellent model for utilitarian reserving more generally.

Section §468A of the Code allows electing taxpayers to deduct amounts contributed to a Fund during the taxable year,<sup>209</sup> but limits the annual contribution to a designated “Ruling Amount.”<sup>210</sup> Determined by

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208. I.R.S. Chief Counsel Adv. 2007-03-007 (Jan. 19, 2007), 2007 WL 121781 (concluding that nuclear decommissioning cost is not an insurance risk and noting that “[t]he obligation to decommission has attached[,] therefore no hazard or fortuity as to the occurrence of decommissioning exists. . . . Thus, no insurance risk is involved.”).

209. I.R.C. § 468A(a) (2006).

210. *Id.* § 468A(b).

an established schedule,<sup>211</sup> the Ruling Amount for each taxable year basically allows the taxpayer to contribute to the fund the total cost of decommissioning (but not more) over the estimated useful life of the power plant at a level-funding rate.<sup>212</sup> On the flip side, the electing taxpayer faces a gross income inclusion when amounts are distributed from the Fund<sup>213</sup> or, barring regulatory exception, certain other events occur.<sup>214</sup> Assuming the amounts were distributed from the Fund and used to cover actual decommissioning costs,<sup>215</sup> the gross income inclusion is offset by a deduction for decommissioning expenses when economic performance occurs.<sup>216</sup>

Although Congress designed the rules set forth in §468A for nuclear power plants facing definite decommissioning obligations, one could readily argue that a similar system would be useful for risks that are more contingent but financially radioactive, environmentally offensive, or threatening in their own right. If, for example, Congress allows companies to call on their contingency reserves (with an offsetting deduction for designated expenditures) as the economy *begins* to slip into a recession (or a given company encounters exigent financial circumstances), they may be able to delay or avoid layoffs, or take other steps to smooth out the volatility of the short- and long-term business cycles. And, to the extent that more large companies are able to bear their own risks, or at least fine tune the balance of risks shifted and those retained, American taxpayers will benefit as their shoulders are relieved of potential bailout burdens.

If the recent past is any indicator, federal bailout infusions, granted in exchange for an equity stake, exacerbate corporate agency costs. So, rather than those costs being borne by the historic shareholder group alone, those costs spread to the larger U.S. taxpaying population. It remains true that as with contextual self-insuring, utilitarian reserving can be attacked as allowing distortion and substantial understatement of income. However, the core premise of utilitarian thought is that the larger societal benefits outweigh individual harms.

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211. *Id.* § 468A(d)(1). Although the Secretary is obligated to review the schedule of ruling amounts during the useful life of the power plant (revising them if necessary), the Secretary may do so more frequently if the taxpayer requests. *Id.* § 468A(d)(3).

212. *Id.* § 468A(d)(2)(A).

213. An exception applies with respect to amounts distributed from the Fund to cover certain costs connected with Fund operations. *Id.* § 468A(c)(1)(A), (e)(4)(B).

214. These events include deemed distributions under § 468A(e)(6), terminations of the Fund under § 468A(e)(7), and a disposition of any interest in the nuclear power plant. *Id.* § 468A(c)(1)(B).

215. The Fund can be used to cover decommissioning costs, to cover operational expenses, and to the extent of amounts not needed for the foregoing, to make investments. *Id.* § 468A(e)(4). For provisions governing the taxation of the Fund, see *id.* § 468A(e)(2).

216. *Id.* § 468A(e)(2)(A).

## CONCLUSION

In light of general judicial rejection and scholarly criticism, the Service officially abandoned its economic family theory in the captive insurance company arena in 2001. As promised, however, the Service continues to analyze certain captive insurance transactions to ascertain whether they incorporate risk shifting and risk distributing, despite the fact that courts have questioned the legitimacy of a risk shifting inquiry and thereby weakened its determinative force. Commentators do not criticize the risk distribution requirement as inherently useless, but they do accurately note that the standard can be used to demarcate true "insurance" only in those contexts in which reliable probability data exists with respect to the designated risk pool.

To the extent the Service or any other entity focuses only on the mere existence of a large number of apparently independent, homogeneous risk units in the designated pool (with very little or no regard for predictive data with respect to that pool), latent investment activity may successfully cloak itself in the garb of "insurance." AIG's so-called "debt insurance" on credit default swaps has brought home that truth and, given the concentration of risk within behemoth AIG, that truth arrived with resounding and devastating force.

Contextual self-insurance represents a healthy and viable means of de-concentrating insurable risk generally, and for companies deemed "too big to fail"—or those operating in certain industries—limited contingency reserving is far more palatable than multi-billion-dollar bailouts and the attendant enhancement of corporate agency costs. Indeed, both contextual self-insuring and limited contingency reserving promise to maximize the common good, whether measured on the national or individual community scale.

