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Office of Chief Counsel
Internal Revenue Service

memorandum

TALudeke

date: **October 16, 2002**

to: **Linda Creswell**
Revenue Agent

from: **Associate Area Counsel**
Natural Resources

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subject: [redacted]
PORC insurance issue

This memo responds to your request for advice on October 1, 2002. It should not be cited as precedent.

In your memo you noted that when the dealership was sold, you originally understood that it paid an unrelated insurance company to assume the liabilities under the service contracts. [redacted]

STATEMENT OF FACTS

[redacted] was incorporated in Texas on [redacted] and is the parent of [redacted], Inc. [redacted] is a holding company and does not engage in any business operation. [redacted], Inc. is an authorized [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted] dealership. [redacted] and [redacted], Inc. file a consolidated return and use the accrual method of accounting. [redacted] percent of the shares of [redacted] are owned by [redacted] [redacted], who also owns [redacted], another auto dealership. That entity is not currently under exam.

[redacted] sells two types of vehicle extended warranty service contracts (VSCs). The first is the manufacturer's contract on which the vehicle's manufacturer is the primary obligor. The

company is not the principal under these VSCs and acts only as an agent, earning a commission on each contract sold. The commission income is correctly reported in the period in which the VSC is sold.

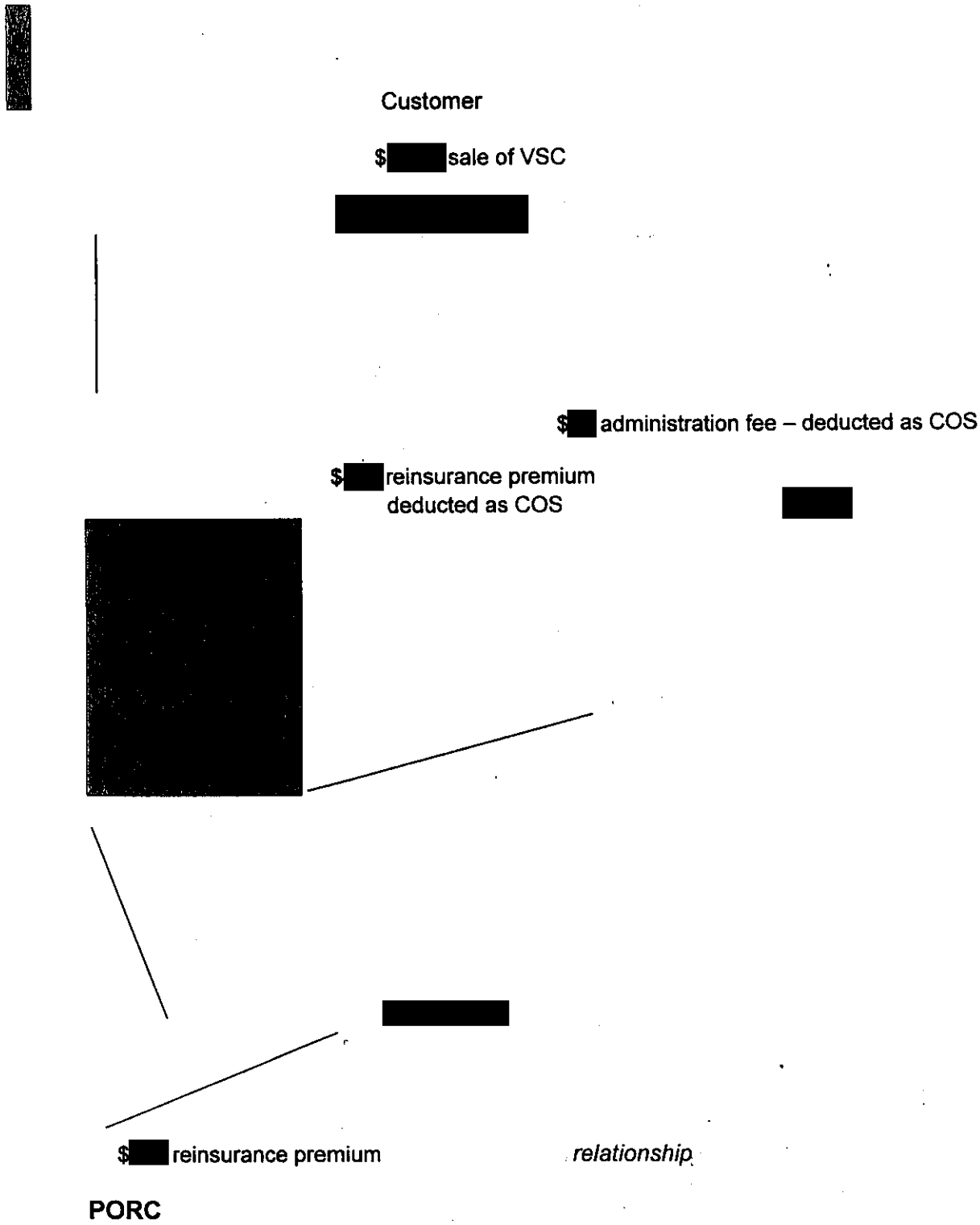
[redacted] acts as primary obligor on the second type of VSC sold. Prior to [redacted], [redacted] purchased reinsurance from a third party to protect its risk under these contracts. During [redacted], it began carrying the dealer-obligor VSCs without the additional insurance. A reserve was established on [redacted]'s books for these [redacted] VSCs and a proper M1 adjustment was made to correct the book income and expense to that allowed for tax.

At the beginning of [redacted], [redacted] again changed its method of accounting for dealer-obligor VSCs it sold by using a dealer / producer owned insurance company (PORC) to reinsure them. The concept was promoted by [redacted] ("[redacted]"), located in [redacted] and [redacted] ("[redacted]"), located in [redacted] Under the direction of [redacted] and [redacted], a reinsurance company named [redacted] (the PORC), was formed [redacted] under the laws of the [redacted]. The statutory home office is recorded as [redacted], which is the same office location as that of [redacted]. The initial capitalization was $[redacted]. The shareholders of the PORC are [redacted], with a [redacted] percent ownership interest, and his two daughters, [redacted] and [redacted], with a combined [redacted] percent ownership interest.

A second PORC, [redacted], was also formed to reinsure the dealer obligor VSCs sold by [redacted], the other dealership owned by [redacted]. This PORC was set up and capitalized in the same way that the [redacted]'s PORC was established.

The PORC made an election to be taxed as a domestic corporation under section 953(d) and elected to be taxed only on investment income under section 831(b).

The cash flow from the sale of VSCs is as follows:



$[redacted] annual fee

[redacted]

Result:

	[redacted]	PORC	[redacted]	[redacted]	[redacted]
Income from customer sale	[redacted]				
Expense: Admin fee	[redacted]				
Reinsurance premium	[redacted]				
Commission income	[redacted]	[redacted]	[redacted]		[redacted]
Annual fee				[redacted]	

[redacted] cedes its insurable risk under the VSC to [redacted], a subsidiary of [redacted], in return for a payment of $[redacted]. [redacted] then cedes its insurable risk to the PORC for $[redacted] and keeps $[redacted] of the payment as its commission.

[redacted] provides claims administration services for the $[redacted] it is paid for each VSC sold. [redacted] claims that [redacted] does not provide any insurance coverage for its fee (even though the promotion materials state that one advantage of participation in the scheme is the insurance policy that [redacted] provides and that the customer is fully protected). [redacted] and [redacted] provide bookkeeping services and tax return preparation for their fee.

The PORC is an offshore entity and does not meet the requirements for bonding and minimum reserves set by the various state insurance boards. It files a Form 1120-PC as a U.S. Property and Casualty Insurance Company. The PORC meets the I.R.C.'s net written premium qualifications for a small insurance company and is taxed on investment income only. Thus, [redacted] takes a deduction for insurance expense of $[redacted] and the PORC does not report the $[redacted] as income because of its election under section 831(b).

In [redacted] or [redacted], the majority shareholder, [redacted], borrowed $[redacted] from the PORC for the purpose of starting a new dealership. A note was signed and dated [redacted] with [redacted]% annual interest. The balance sheet of the PORC, however, does not reflect the shareholder receivable until [redacted]. [redacted] said that all payments were current. It should be noted that Alexander also borrowed $[redacted] from the second PORC that acts as reinsurer for his other dealership, [redacted].

There are two types of customer claims under the dealer-obligor VSCs. The first is a covered repair done by someone other than [redacted], normally because the vehicle owner is out of the area. The second is a covered repair done by [redacted]. The steps are as follows:

The customer takes the vehicle into an "out of area" repair shop

1. The "out of area" repair shop submits a claim to [redacted].
2. [redacted] administration approves the claim.
3. [redacted] pays the "out of area" repair shop.
4. [redacted] files a monthly report with [redacted] requesting reimbursement.
5. [redacted] reimburses [redacted].
6. [redacted] bills the PORC for the amount it paid [redacted].
7. The PORC pays [redacted] from its reserves at retail.
8. The payment is included into [redacted]'s income.

The customer takes the vehicle into the [redacted]'s repair shop

1. [redacted] approves the claim.
2. [redacted] repairs the vehicle.
3. [redacted] includes the cost of parts, etc in the COS accounts.
4. [redacted] bills the PORC for the retail amount.
5. The PORC pays [redacted] from its reserves at retail.
6. The payment is included into [redacted]'s income.

LEGAL ANALYSIS

To determine whether payments to related parties can be deducted as insurance, three factors must be examined: (1) whether there is insurance risk; (2) whether the insurance involves risk shifting and risk distributing; and (3) whether the arrangement is insurance in its commonly accepted sense.[1] *Amerco v. Commissioner,* 96 T.C. 18, 38 (1991), *aff'd,* 979 F.2d 162 (9th Cir. 1992).

As you note in your write-up, there is an insurable risk in this case. The payment by the PORC does not change this fact. It does, however, affect the analysis of the remaining factors.

"The test [for insurance] continues to be whether, considering all of facts, the risk of loss was shifted away from the taxpayer that seeks to deduct insurance premiums." *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948, 957 (1985). Risk shifting can be separated into technical and substantive components. *Amerco,* 96 T.C. at 40-1. Technical risk shifting focuses on the formalities associated with the payments such as whether the payments "were written like insurance, regulated as insurance, and involved separate, viable parties." *Id.* at 41. The captive

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[1] Courts addressing captive insurance spend little time addressing this issue. In fact, if a captive meets the risk shifting and risk distributing requirements, it's almost certain to meet this requirement as well. *See, Amerco*, 96 T.C. at 42-3. Thus, this issue is not addressed further.

is a separate entity only if losses in the captive will not impact the insured party. *Humana, Inc. v. Commissioner*, 881 F.2d 247, 252 (6th Cir. 1989) ("There is simply no direct connection in this case between a loss sustained by the insurance company and the affiliates of Humana Inc. ..."). Substantive risk shifting looks at whether the entity receiving the payments is the equivalent of a reserve for losses and whether the entity writes insurance for other parties, including brother-sister corporations. *Amerco*, 96 T.C. at 41 .

The most important factor in determining whether risk has shifted is who ultimately bears the risk of loss. *See Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835, 840-2 (6th Cir. 1995). (collecting cases). *Malone & Hyde* addressed the corporation's use of an offshore captive. Malone made payments to an unrelated insurance company which were then ceded to a captive in Bermuda. Malone entered into an agreement with the unrelated company to indemnify it against any losses incurred by the captive. Noting that such an agreement was not present in *Humana*, the court concluded that the thinly-capitalized captive was a sham:

> If Humana's scheme had involved a thinly-capitalized captive foreign insurance company that ended up with a large portion of the premiums paid to a commercial insurance company as primary insurer, and had included a hold-harmless agreement from Humana indemnifying the unrelated insurer against all liability, we believe the result in *Humana* would've been different.

Id. at 842.

Other courts have reached similar conclusions, finding that no risk shifted when hold harmless or similar agreements were in place. *Carnation Co. v. Commissioner,* 640 F.2d 1010 (9th Cir. 1981); *Stearns-Rogers Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985).

It's also important whether the supposed insurance company is regulated and well capitalized. In *Malone & Hyde*, for example, the court noted that the captive was not regulated as an insurer and was not well capitalized. Similarly, in *Carnation*, the court noted that no outside party would have entered into an agreement with the undercapitalized captive. But standing alone, the fact that the captive is not regulated as an insurance company is not determinative. *Ocean Drilling & Exploration Co. v. United States*, 92-1 USTC ¶ 50,018 (Ct. Cl.), *aff'd*, 988 F.2d 1135 (Fed. Cir. 1993)(holding that the fact unrelated insurance companies did business with the captive and required it to meet certain standards was in effect a substitute for regulation).

In addition to risk shifting, risk distribution must be present in a legitimate insurance arrangement. "'Risk-distributing' means that the party assuming the risk distributes his potential liability, in part, among others." *Beech Aircraft Corp. v. United States*, 797 F.2d 920, 922 (10th Cir. 1986). "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." *Clougherty Packing* , 811 F.2d at 1300. This generally requires that the insurance company has some unrelated business, though how much unrelated insurance is required is

unclear. *Harper Group v. Commissioner*, 979 F.2d 1341, 1342 (9th Cir. 1992) (collecting cases and noting that courts have held that as little as 29 percent of business with unrelated parties was sufficient and that other courts held that 2 percent or less unrelated business was insufficient). One court, however, held that distribution of risk of among brother-sister corporations was sufficient. *Humana*, 881 F.2d at 56-7. No courts have decided whether distribution of risk among companies with common owners is sufficient. Two courts have addressed a captive in these circumstances. *Crawford Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Oh. 1985); *Wright v. Commissioner*, T.C. Memo. 1993-328, 66 T.C.M. (CCH) 214.

Crawford Fitting addressed a captive set up by a manufacturing company. An individual was the sole owner of Crawford, and that same individual, his spouse, and his child indirectly (through intervening corporations) owned 80 percent of the captive. Focusing on Crawford, the court noted that losses by the captive would not affect the net worth of Crawford. Thus, despite the common ownership, risk was shifted by the payment to the captive. Because the captive also insured some unrelated parties, the court also found that risk was distributed and held that the payments to the captive were deductible as insurance.

Another case addressed a captive that insured related, but not brother-sister, corporations. *Wright v. Commissioner*, T.C. Memo. 1993-328. In that case, an individual that owned several car dealership set up a captive that reinsured various products sold by the dealerships. Because there was no risk shifting or risk distribution, the court concluded that the transaction was a sham. Though the facts in *Wright* are similar to those here, there are notable differences. The taxpayer in *Wright* engaged in many fraudulent transactions with the captive and maintained total control of the captive's money. Thus, this case is not a particularly useful precedent.

Summary

Payments to captive insurers are deductible only if there is risk shifting and risk distribution. Risk shifting requires the actual transfer of risk to the captive. Risk distribution requires that the captive distribute the risk among several parties. Absent these facts, payments to captives are not deductible.

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[redacted] If you need further assistance, please contact Todd Ludeke at (972) 308-7926.

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By:_____
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