Federal Income Taxation of Self-Insurance Techniques
by Robert J. Finger
Reviewed by Richard E. Sherman

In the paper, "Federal Income Taxation of Self-Insurance Techniques", Mr. Finger presents an extensive analysis of key issues in this area of growing interest. In so doing, he has made a significant contribution to existing literature on this subject. By and large, he has carefully documented his positions on key issues and has clearly and logically organized his discussion of pertinent statutes, court decisions and private letter rulings. In so doing, he has performed a valuable service to those concerned with the tax implications of various alternatives to insurance.

In preparing this review, I have relied heavily on the expertise of Mr. Michael Heitz, a tax manager in the New York office of Coopers & Lybrand. His assistance, as well as that of Mr. Don Steffen, a taxpartner from our San Francisco office, was invaluable in completing this review.

We have organized our comments and observations on specific points according to the same subsections as Mr. Finger's paper. While most of our comments are of a critical nature, we do not intend to imply that this is our general view of this lengthy paper, but only that regarding the specific points cited.

A. Rules Applicable to Insurance Companies

Mr. Finger states on page 30 that statutory accounting rules may provide insurers with a "double deduction". While the tax accounting for loss reserves, loss adjustment expense reserves and earned premiums is unique to insurance companies, we believe that it would be misleading to refer to such conventions as resulting in a "double deduction".

B. Deductibility of Contingent Reserves

A more appropriate title for this section would probably be "Treatment of Estimated Losses by Non-Insurance Companies", since contingent reserves refers to a more narrow scope than is covered by this section. We would also mention, with respect to the discussion in the latter half of page 43, that Private letter Ruling 8026018 regarding advance deposits should be cited. In this Ruling, the IRS concluded that advance deposits do not constitute unearned premiums. A more careful discussion of this ruling may be found on page 9 of Critical Tax Issues Confronting the Insurance Industry.[1]

[1] Critical Tax Issues Confronting the Insurance Industry, Gerald I. Lenrow and Michael J. Cuddy, 1981. Coopers & Lybrand. p.9.

C. The Requisite Transfer of Risk

We were clearly surprised that this section did not include any discussion of Revenue Ruling 77-316 - which has been viewed as a landmark in this regard. Only one footnote is devoted to this ruling which deserves the careful study of anyone interested in the subject of Mr. Finger's exposition. As the IRS states at the beginning of this ruling, it provides examples which "illustrate the tax consequences of so-called insurance premiums paid by a domestic corporation and its domestic subsidiaries to the parent's wholly-owned foreign 'insurance' subsidiary and compensation received from the foreign 'insurance' subsidiary with respect to 'insured' losses incurred by the domestic parent and subsidiaries". Revenue Ruling 77-316 is carefully and succinctly worded. It articulates the Service's position regarding the "economic family" concept to which Mr. Finger only indirectly alludes.

Mr. Finger concludes this section with the following paragraph:

> In summary, premium payments without a transfer of risk are probably not deductible. This makes wholly-owned captives, whether foreign or domestic, and deposit-with-indemnity plans unattractive. Payments to association captives are <u>deductible</u> (emphasis supplied), as are the entire amount of payments that have only a small portion

of risk transfer.

We would caution the reader against drawing specific conclusions from the generalizations in this closing paragraph. For example, to say that a wholly-owned captive is unattractive is to conclude that Sears has not found Allstate to be a profitable and attractive venture. We do not believe that Sears has regretted its decision to venture into the insurance business! In short, all that should really be concluded here is that, from a tax standpoint, wholly-owned captives are probably less attractive than association captives.

The last sentence of Mr. Finger's above-cited closing paragraph should likewise be received with caution. To say that "payments to association captives are deductible" is a strong, sweeping statement which has the potential of misleading the unwary. Evidently, Mr. Finger's statement is founded on two private letter rulings (8111087 and 8111101), which the Service arguably maintains cannot serve as precedent, and a specific revenue ruling (78-338) with respect to a captive insuring thirty oil companies which Mr. Finger cites on page 50. We may only conclude that, to date in certain instances, premium payments to association captives have received favorable treatment by the IRS.

One additional point should be made regarding the last sentence of Section C, which reads:

> Payments to association captives are deductible, as are the entire amount of payments that have only a small amount of risk transfer.

The problem here is in what constitutes a "small" amount of risk transfer. On page 50, Mr. Finger states:

> The entire amount of retrospectively-rated premiums are deductible, even though the insurance charge and expenses in the basic charge may be a fairly small percentage of the total premium.

We believe that usage of "small" and "fairly small" in these contexts leaves the reader with the impression that a minimal degree of risk transfer will satisfy the IRS. We believe that a more accurate phraseology at this point is that a <u>reasonable</u> degree of risk transfer is required to permit deductibility. Although the question of what constitutes a "reasonable" degree of risk transfer has not been clearly defined, this guideline is, in all probability, more strict than one would infer from the terms "small" or "fairly small".

D. Taxation of Foreign Corporations

The last sentence of the first paragraph on page 54 makes the statement:

> The 30% withholding tax is imposed on the United States source, which is the entity making the income payment.

This statement should be clarified by noting that only the obligation to withhold, and not the tax itself, is imposed on the U.S. source.

With regard to the last sentence of the first paragraph of page 55, we believe that a more correct wording would eliminate the second to the last word, "reinsurance", so that Mr. Finger's statement would apply to all premium.

In the middle of page 56, it is stated, "The excise tax is not levied on transactions made through a licensed surplus lines broker". This should be qualified to indicate that it applies to brokers having the authority to bind the foreign company.

D.1. Activities Constituting a U.S. Trade or Business

At the top of page 58, Mr. Finger makes the statement

> Since the taxpayer was represented in the U.S. by an agent, he was held to be engaged in a U.S. trade or business.

We would add, as a point of clarification, that the IRS took this position because the agent was an exclusive agent for a foreign company (Revenue Ruling 70-424).

Another point requiring clarification exists with respect to the last sentence on page 59:

> Importantly, activities conducted by independent contractors do not constitute a U.S. trade or business for their employer.

In this context, the term "employer" appears inconsistent with the term, "independent contractor".

D.2. Taxation of Foreign Insurers Engaged in a U.S. Trade or Business

We would offer the following points of clarification with regard to the discussion in this section.

- In the first paragraph, it is stated, "U.S. source income, not effectively connected, is taxed at a 30% rate under the general withholding provisions". We would add, parenthetically, that the 30% rate may be replaced by a treaty rate, if it is lower.

- In the middle of page 63 , it is stated, "The source of interest income is the residence of the payor". Some statutory exceptions exist and thus, a more accurate wording would preface this sentence with the word, "generally".

- The second to the last sentence of page 64 reads, "All other U.S. source income is considered to be effectively connected income". Again, this statement should be qualified by adding the phrase, "subject to applicable tax treaties".

- On page 66 , Mr. Finger states that "Investment income attributable to excess surplus probably is not effectively connected". We believe that "probably" is too strong a word, and would instead preface this sentence with the phrase, "It may be argued that...".

- The last sentence of the middle paragraph of page 66 contains the confusing sentence, "If the insurer does not intend to invest in the U.S., it will have no U.S. source investment income". Intention to invest is irrelevant and has no bearing whatsoever. Clearly, the fact of what actual investments have been made is the determining factor.

- On page 67, the middle paragraph begins with the sentence, "In summary, if a foreign insurer is engaged in a U.S. trade or business, its underwriting income would be taxable as if earned by a domestic corporation". We would add that, according to I.R.C. Section 882(c)(2), a foreign company is eligible for deductions only if it files a return. Otherwise, it will be taxed on its gross income.

D.3. <u>Taxation of U.S Shareholders of Foreign Corporations</u>

Mr. Finger discusses at length the taxability of investment income attributable to capital and surplus on pages 76-78. He concludes that U.S. shareholders of a CFC should not be taxed on investment income attributable to capital and surplus. We would openly state that we disagree with this conclusion and would offer in support of this position a statement made by Mr. Finger in the middle of page 76:

> It would appear, however, that since reference is made to the taxation of domestic insurers and since domestic insurers must include investment income in their taxable income, the insurer's investment income is likely to be taxable under section 953. (our underlining)

Since investment income derived from capital and surplus is not distinguished on tax returns for domestic companies, we are not aware of any reasonable basis for making such a distinction with respect to foreign companies.

Other points of less importance relative to this section are as follows:

- In the last sentence of the first paragraph of page 72, it is stated, "eleven persons could own equal shares of the foreign insurer" and thereby avoid CFC status and taxation. We would note that certain indirect and constructive ownership provisions must be satisfied. Accordingly, such persons should be viewed as unrelated shareholders.

- At the bottom of page 73, reference is made to "foreign U.S. shareholders". Some clarification is needed of this seeming contradiction in terms.

- Another significant exclusion which could be included in the last paragraph of page 83 is that of municipal bonds and "yankee" bonds - those issued by foreign governments and underwritten by domestic brokers and dealers.

- On page 85, Mr. Finger states, "Foreign tax credits are only available to corporations...". This is not a correct statement since individuals can take foreign tax credits in certain circumstances (See I.R.C. Sections 901(a) and 901(b)).

- In the middle of page 86, it is stated, "This income probably includes investment income on unearned premium and loss reserves". We believe that the word "probably" should be replaced by "will be" to emphasize that this income is taxable.

III. Case Study

This section provides some helpful examples illustrating the type of comparative analysis which should be completed in reviewing the tax implications of several major alternatives to traditional coverage.