

Financial Services

Captive Insurance Update

Bermuda

PRICEWATERHOUSECOOPERS 

Risk Shifting Among Partners

April 22, 2008

Alert Number: 08-04

In Technical Advice Memorandum 200816029, the IRS has considered whether the general partner or the limited partnership should be deemed the insured entity under a purported insurance arrangement for purposes of evaluating whether sufficient risk distribution exists among the entities to treat the arrangement as insurance for federal income tax purposes.

P is the common parent of a group of affiliated entities classified as corporations, partnerships, and disregarded entities for federal income tax purposes. Among the entities is IC, a corporation intended to provide insurance coverage arising from workers' compensation, automobile liability, and general liability for some or all of the other member entities. Among these covered entities are entities organized as limited partnerships under local law and classified as partnerships for federal income tax purposes. Typically, the limited partnerships have one general partner and one limited partner. The general partner is either a corporation or another partnership. The ultimate general partner is a corporation indirectly owned by P. At least one involved entity is a limited liability company with more than one member.

In addition to highlighting the requirement that there be both risk shifting and risk distribution under *Helvering v. Le Gierse*, 312 U.S. 531 (1941), and that the risk must contemplate the fortuitous occurrence of a stated contingency under *Commissioner v. Treganowan*, 183 F.2d 288, 290-91 (2d Cir. 1950), the ruling also emphasizes that the loss must be an economic loss versus an investment risk. The IRS also considered decades of other case law including *Clougherty Packing Co. v. Commissioner* and *Humana, Inc. v. Commissioner*. The IRS also considered decades of other case law including *Clougherty Packing Co. v. Commissioner* and *Humana, Inc. v. Commissioner*. Moreover, in determining whether there were sufficient insureds (e.g., the 12 insureds set forth in Rev. Rul. 2002-90 and Rev. Rul. 2005-40), the IRS considered the question of whether an organization is an entity separate from its owners or whether it is disregarded for federal tax purposes.

The IRS concluded where an entity classified as a partnership for federal income tax purposes is of the type that has a general partner(s), because the general partner(s) is ultimately liable for the liabilities of the entity (in excess of the assets of the partnership), it is the general partner(s) whose risk of loss is shifted under the insurance contract; hence it is the general partner(s) that should be considered the insured under liability coverage for purposes of evaluating whether an arrangement constitutes insurance for federal income tax purposes (the IRS caveated their conclusion where local law subjected the limited partners to the same levels of liability as the general partner). In addition the IRS determined that if the entity classified as a partnership for federal income tax purposes is of the type that does not have a general partner(s); that is, under applicable law no liability of the entity can in the ordinary course attach to anyone other than the entity, it is the entity that should be considered the insured under liability coverage for purposes of evaluating whether an arrangement constitutes insurance for federal income tax purposes.

Financial Services

Captive Insurance Update

Bermuda



PwC Observes:

The Service's analysis and conclusions disregard the fact that it is the assets of limited partnership that are protected under the liability insurance arrangement. In fact, a limited partner is subject to the same protection under the liability insurance as a shareholder in a corporation. The fact that residual liability (in excess of the assets of the partnership) rests with the general partner(s) would imply that there are actually two insureds, the limited partnership and the general partner.

For additional information, please contact your PricewaterhouseCoopers Tax Management Team member: Rick Irvine at 441-299-7136 (richard.e.irvine@bm.pwc.com) or Laurie Bailey at 441-299-7104 (laurie.bailey@bm.pwc.com).

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY PWC TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers, its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.