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### IRS Issues Guidance with Respect to "Cell" Arrangements II

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In Rev. Rul. 2008-8, the IRS provides guidance through examples of when a cell of a protected cell company is treated as insurance for federal income tax purposes, and when amounts paid to these cells is deductible as "insurance premiums" under Section 162.

Generally, a protected cell company (PCC) is a legal entity that has established multiple accounts, or cells, each of which has its own name and is identified with a specific participant, but is not treated as a distinct legal entity. Each cell is funded by its participant's capital contribution and by "premiums" collected with respect to contracts to which the cell is a party. Each cell is required to pay out claims with respect to contracts to which it is a party. The income, expense, assets, liabilities, and capital of each cell are accounted for separately from any other cell and of PCC generally. The assets of each cell are statutorily protected from the creditors of any other cell and from the creditors of PCC.

In the ruling, the IRS provides the following two examples:

Each year, X, a domestic corporation that owns all the preferred stock issued with respect to Cell X, enters into a one-year contract whereby Cell X "insures" the professional liability risks of X, either directly or as a reinsurer of those risks. The amounts X pays as "premiums" under the annual arrangement are established according to customary industry rating formulas. In all respects, X and Cell X conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties. Cell X does not enter into any arrangements with entities other than X. Cell X is adequately capitalized relative to the risks assumed under that arrangement.

Y, a domestic corporation, owns all the preferred stock issued with respect to Cell Y, as well as all of the stock of 12 domestic subsidiaries that provide professional services. Together, the 12 subsidiaries have a significant volume of independent, homogeneous risks. Each year, each subsidiary of Y enters into a one-year contract with Cell Y whereby Cell Y "insures" the professional liability risks of that subsidiary, either directly or as a reinsurer of those risks. The amounts charged each subsidiary as "premiums" under the annual arrangements are established according to customary industry rating formulas. None of the subsidiaries have liability coverage for less than 5 % nor more than 15 % of the total risk insured by Cell Y. Cell Y retains the risk that it insures from the subsidiaries. In all respects, Y, Cell Y, and each subsidiary, conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties. Cell Y does not enter into any arrangements with entities other than Y or its subsidiaries. Taking into account the total assets of Cell Y, both from capital contributions from Y and from amounts received pursuant to the arrangements the subsidiaries of Y, Cell Y is adequately capitalized relative to the risks assumed under those arrangements.

**PwC Observes:** The facts as laid out in example Y mirror the facts the IRS set forth in Rev. Rul. 2002-90.

Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Reg. Sec. 1.162-1(a) provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident or other similar losses in the case of a business. To be eligible for these insurance premium deductions, a company must satisfy the requisites of an insurance company under Sections 816(a) and 831(c). In addition, the U.S. Supreme Court has explained that in order for an



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arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. The ruling cited all relevant captive case law.

According to the IRS, the arrangement between X and Cell X is akin to an arrangement between a parent and its wholly-owned subsidiary, which, in the absence of unrelated risk, lacks the requisite risk shifting and risk distribution to constitute insurance. Because Cell X does not enter into arrangements with any policyholders other than X, the arrangement between X and Cell X is not an insurance contract for federal income tax purposes, and X may not deduct amounts paid pursuant to the arrangement as "insurance premiums" under Section 162.

Under the arrangements between the 12 subsidiaries of Y and Cell Y, the IRS found that the subsidiaries shift to Cell Y their professional liability risks in exchange for premiums that are determined at arms-length. Those premiums are pooled such that a loss by one subsidiary is not in substantial part, paid from its own premiums. The subsidiaries of Y and Cell Y conduct themselves in all respects as would unrelated parties to a traditional insurance relationship. Had the subsidiaries of Y entered into identical arrangements with a sibling corporation that was regulated as an insurance company, the arrangements would constitute insurance and amounts paid pursuant to the arrangements would be deductible as insurance premiums under Section 162. The fact that the subsidiaries' risks were instead shifted to a cell of a protected cell company, and distributed within that cell, does not change this result. Accordingly, the arrangements between Cell Y and each subsidiary of Y are insurance contracts for federal income tax purposes and amounts paid pursuant to those arrangements are insurance premiums, deductible under Section 162 if the requirements for deduction are otherwise satisfied.

**PwC Observes:** In the case of Y, where the IRS found that the requisite risk shifting and risk distribution was present, it is important to note that in the fact pattern represented, neither Y nor any subsidiary of Y guaranteed Cell Y's performance, and all funds and business records of Y, Cell Y, and each subsidiary, are separately maintained. Further, Cell Y does not loan any funds to Y or to any other subsidiary, nor enters into any arrangements with entities other than Y or its subsidiaries.

For additional information please call Anthony DiGilio at (202) 414-1702 or contact your local insurance tax professional. Please visit us at: <http://www.pwc.com/us/insurance/tax>

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