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Federal Taxation Concepts in Corporate Risk Assumption: Self-Insurance, the Trust, and the Captive Insurance Company

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FEDERAL TAXATION CONCEPTS IN CORPORATE RISK ASSUMPTION: SELF-INSURANCE, THE TRUST, AND THE CAPTIVE INSURANCE COMPANY

I. INTRODUCTION

This age of technical, economic, and political discontinuity[1] has made corporate property and liability losses a significant cost of doing business.[2] Concomitantly, there has been an expansion of the insurance industry. But to an increasing degree, major corporations are directly participating in the risks associated with these uncertainties, since complete risk transfer to an unrelated insurer is often impossible.[3] Thus, alternative financial plans are developing. This Comment discusses the federal income tax treatment of the principal methods for financing corporate self-assumption of loss from such property and liability risks. These financing methods are retrospectively rated insurance policies,[4] self-insurance,[5] trusts,[6] and the captive insurance company.[7]

1. *See, e.g.,* Drucker, *Preface* to P. Drucker, The Age of Discontinuity at ix-xi (1969).

2. *See* D. Bickelhaupt, General Insurance 64-65 (9th ed. 1974) [hereinafter cited as General Insurance].

3. A survey which reflected this phenomenon found that in Fortune's top 500 industrial corporations, five out of six were self-insuring some portion of their corporate risk and most of these expected their percentage of risk acceptance to increase in the future. Survey by Fortune Market Research, How Major Industrial Corporations View Property/Liability Insurance 21-23 (Oct. 1973).

4. These plans provide that the insured will ultimately pay an adjusted premium which is calculated from his actual loss experience during the policy term. An element of insurance, *i.e.*, risk transfer, can be provided by performing this calculation after truncating the individual loss severity at a defined maximum and establishing an absolute minimum and maximum value for the policy premium. At the inception of the program, the insured pays a deposit, termed the deposit premium, which is subject to the adjustments indicated above. W. Rodda, Property and Liability Insurance 431 (1966).

5. "[S]elf-insurance is the conscious retention of risk, the level of which has been limited within the financial capacity of the firm, emanating from a distribution of exposures which permit reasonable predictions as to future loss probabilities." R. Goshay, Corporate Self-Insurance and Risk Retention Plans 21 (1964) (italics removed). *See generally* C. Kulp & J. Hall, Casualty Insurance 747-50 (4th ed. 1968); *see also* R. McRell, Self Insurance and Captive Subsidiary Concepts 4-5 (1973). There is a consensus in favor of restricting the term to instances where there is a structure analogous to the operation of a sound insurance company. General Insurance, *supra* note 2, at 27-28.

6. Although trusts are more commonly used for the prefunding of corporate pension plans and other employee benefits, *see, e.g.,* General Insurance, *supra* note 2, at 336-37, there is no reason why such a vehicle could not be used to prefund other corporate liabilities. For a general discussion of insurance trusts where the proceeds of the policy are paid to a trustee who is responsible for their investment and distribution to designated beneficiaries or claimants, *see* 5 G. Couch, Cyclopedia of Insurance Law § 29:37-:55 (2d ed. 1960 & Supp. 1977).

7. Most authorities would define a captive insurance company as one which primarily insures the risks of its parent corporation. *See* D. MacDonald, Corporate Risk Control 145-50 (1966); R. McRell, Self Insurance and Captive Subsidiary Concepts 83 (1973). McRell defines four types of captives covering a spectrum from the "pure" captive, which deals exclusively with its parent, to

Since most of the risk-related losses and expenses will ultimately be deductible to the corporation, timing considerations associated with these deductions are essential in distinguishing the various financing alternatives. Therefore, this Comment will concentrate on the income tax and accounting treatment of reserves for losses and expenses not yet paid. In those cases where two distinct legal entities are involved (such as a parent and a captive insurer), the consolidated tax and accounting positions will also be developed.

A. *The Concept of Risk*

Corporations, like individuals, exist in environments which expose them to a diverse collection of risks.[8] A business corporation must display a continuing ability to sustain successfully the financial ramifications of risk exposure. In this general sense risks affect all corporate activity. However, practical usage distinguishes those uncertainties surrounding the production, financing, and demand for the corporation's products and services as management or speculative risks.[9] Random hazard risks,[10] on the other hand, are generally characterized as pure risks, that is to say, unlike the opportunity for both profit and loss associated with management risks, there is only a chance of loss or no loss.[11] Examples include property loss due to fire and vicarious liability for the tort of an employee.

Corporate random hazard risks can be conveniently, but imprecisely, divided into property (first-party) and casualty (third-party) classes.[12] The first

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the "profit center" captive, where the underwriting of the parent's risks is incidental to its third-party insurance business.

The single state statute on this subject distinguishes a "pure captive insurance company," which must generally limit its operation to "the risks . . . of its parent," and an "association captive insurance company," which must limit its operations to members of the given association. Colo. Rev. Stat. §§ 10-6-103(9), -103(4) (Cum. Supp. 1976).

8. J. Athearn, Risk and Insurance 13 (2d ed. 1969). The term "risk" has two distinct uses in insurance terminology. The first is synonymous with type of loss, as when one refers to the workers' compensation risk. Random House Dictionary of the English Language 1236 (unabr. ed. 1966). The second usage refers to situations where there is a potential for variation between what is expected to happen and what might happen, *i.e.*, the concept of uncertainty. General Insurance, *supra* note 2, at 5; R. Mehr & B. Hedges, Risk Management: Concepts and Applications 41 (1974). In this Comment, the intended meaning should be obvious from the context of the usage.

9. R. Mehr & B. Hedges, Risk Management in the Business Enterprise 4-8 (1963). The authors define the concept of management risk to include the categories of market, financial, and production risks. They also define the broader class of speculative, or dynamic, risks as encompassing management risks as well as political risk and innovation.

10. Terminology in this area has not been standardized. One text uses the term "static risk" to describe the same concept described here as a random hazard risk. *See* R. Mehr & B. Hedges, *supra* note 9, at 8-11.

11. General Insurance, *supra* note 2, at 10.

12. Workable definitions for these two major classes can be found in Insurance Information Inst., [1977] Insurance Facts Property Liability Marine Surety 72. However, the insurance industry has not developed a precise classification system which has been universally accepted. *See* C. Kulp & J. Hall, Casualty Insurance 16-17 (4th ed. 1968).

is composed of risks such as fire, storm, or theft, which jeopardize the real and personal property assets of the particular corporation. The second class, the casualty exposures, includes various liability classifications, which are principally automobile liability, workers' compensation, product liability, and general liability.[13] This Comment deals exclusively with the financial implications of random hazard risks.

B. *The Growth in Risk Assumption*

Insurance operates as a financial mechanism where the collective future losses of a large number of individual insureds are reasonably predictable. Pooling such individual risks reduces the potential financial loss of any one participant.[14] Not all risks, however, justify the procurement of insurance. Indeed, the traditional concept of insurance is to protect against the unexpected event which has a substantial impact on the financial well-being of the insured.[15]

As the size of a corporation increases, its ability to sustain variations in its earnings caused by random losses becomes great enough to make some degree of risk retention a viable policy.[16] Self-retention of risk has gained widespread acceptance as a result of the economic benefits it offers and/or the absence of any alternatives. More direct involvement in risk taking is becoming the norm for many business corporations,[17] nonprofit organizations,[18] and government

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13. General Insurance, *supra* note 2, at 792 n.1; C. Kulp & J. Hall, *supra* note 12, at 15-19.

14. Reducing risk by transfer and combination is the essence of the concept. I. Pfeffer, Insurance and Economic Theory 53 (1956); *see* General Insurance, *supra* note 2, at 29-31.

15. *See generally* W. Vance, Handbook on the Law of Insurance § 1, at 4-7 (3d ed. 1951).

16. The theoretical determination of optimum retention level is often reached by considering the impact of an unbudgeted loss on the company's present and future financial condition. Warren, McVeigh, Griffin & Huntington, *Risk Retention*, Rep. No. A-12, in Practical Risk Management 2-3 (1975). In practical terms, however, this retention level is usually established by using a rule of thumb relationship with annual revenues, after-tax earnings, earnings per share, or allowable budget variation. *Id.* The determination of retention level has accounting significance only if set high enough so that there could be a material effect on the overall financial performance of the corporation, given adverse loss experience. *See* R. Anthony, Management Accounting 39 (3d ed. 1964).

17. *See, e.g.*, Cray, *Insurers, in a Paradoxical Trend, Help Companies Set Up Self-Insurance*, N.Y. Times, May 9, 1977, at 43, col. 1; Kloman, *Captive Insurance Companies—1976*, 3 Risk Management Rep. No. 1, 12, 12-13 (Jan. 1976). *See also* Stevenson, *Captive Insurance—Risk Replaces Premiums*, N.Y. Times, May 29, 1977, § 3, at 1, col. 1.

18. There is a movement among hospitals to use captive insurance companies to insure their medical malpractice exposures. Harsham, *Offshore Medical Insurance: Is It the Answer for You?*, Med. Econ., Feb. 7, 1977, at 214. Several universities, including Harvard University, the University of Pittsburgh (private institutions), and the University of Minesota (a public institution) have begun to employ the captive insurance concept in their risk management plans. *Minnesota Sets First Public College Captive*, Bus. Ins., June 27, 1977, at 1, col. 1. Although most of this interest among universities has been prompted by their medical malpractice exposures, a broader captive role in the general liability area may be observed in the future. *See id.* at 33, cols. 3-5.

units.[19] Minimizing costs is the basic rationale for their policy of risk assumption. For example, when large entities procure insurance for anticipated losses, the result is often a fruitless dollar trading exercise where the insurance company simply uses the collected premiums to pay that insured's losses. Large organizations have begun to realize that they bear the ultimate financial responsibility for at least routine losses over an extended period of time.[20] Insurance companies, as profit-making organizations, have invoked this self-evident proposition by continually reviewing loss experience and increasing rates where necessary so that collected premiums will exceed ultimate losses and expenses.[21]

Aside from the avoidance of expensive dollar trading, another financial incentive for self-assumption programs is that special efforts in loss control or safety programs will immediately return cost savings. Of course, such reductions in expected losses should also be recognized by traditional insurers who would reduce premiums accordingly. In reality, however, this mechanism of rate adjustment is a slow one and, depending on the size of the company, might never be fully recognized using standard actuarial ratemaking procedures.[22] Thus, the economic benefits derived from self-retention of risk are so significant that some degree of self-retention is practiced by nearly every major corporation in operation today.[23]

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19. *See* Hudson, *Soaring Premiums for Risk Coverage Troubling Suburbs*, N.Y. Times, Mar. 20, 1977, § 1, at 1, col. 3; Minard, *The Premiums on City Life*, Forbes, Mar. 15, 1977, at 96, 98.

20. This conclusion is consistent with the concept of risk as uncertainty involving an outcome. "Those losses which occur with predictable regularity do not represent risks but a . . . cost of operation . . . which is (or should be) normally retained." Warren, McVeigh, Griffin & Huntington, *Risk Retention*, Rep. No. A-12, in Practical Risk Management 1 (1975).

Acceptance of this principle has been gaining among the corporations. Some managements, of course, will continue to "become highly critical, and even fearful, when there is a $500 fire loss with no insurance to cover it." Parrett, *Risk Retention*, in Risk Management 53 (H. Snider ed. 1964). More enlightened companies, however, recognize that "[i]t is not sound business practice . . . to spend unnecessary premium dollars for so-called protection at exposure levels that do not represent true 'risks' to the firm." *Id.* at 65.

21. There is a growing recognition that insurance companies do not shoulder the burden of losses alone, but rather pass such costs to the insured public. *See, e.g., The Litigation Binge: Suing Ourselves into Bankruptcy*, Forbes, Sept. 1, 1975, at 63.

22. Insurance rating emphasizes experience on an industrywide basis as opposed to that of any individual company. "An important corollary to understanding the underwriting function is the fact that most insurance prices are based upon an *average* rate for an entire class or group." General Insurance, *supra* note 2, at 142. Standard procedures usually develop premium rates in accordance with traditional indices of loss exposure, such as rating product liability by the company's dollar sales volume or workers' compensation by its payroll. *See* J. Athearn, Risk and Insurance 496 (2d ed. 1969). Ironically, a manufacturer who, as a result of improved safety features, increases the price of his product could experience higher premiums because of the associated increase in sales revenue. Insurance Services Office, Product Liability Insurance 12 (1976).

23. Many proponents of the concept of corporate risk management see the transfer of risk to a third party by standard insurance contracts as the exception rather than the rule in structuring corporate policy. "Contracts of insurance are the principal means for financing losses too large to

A second motive for self-assumption of risk is the absence of an insurance market. There are industries for which traditional insurance protection is unavailable at any price because of the perceived catastrophic risk potential and the relatively small premium volumes involved.[24] While risk transfer to private insurers is impossible in such cases, the alternative of assuming the risks of self-retention may also be unacceptable. For this reason, some form of government involvement has been necessary either to establish an insurance market[25] or to limit the liability of those potentially responsible in the event of a loss.[26]

C. *The Alternative Methods of Risk Assumption*

The most traditional method of effecting corporate self-retention of risk is to contract with the insurer so that the premium is closely determined by the actual losses incurred. Retrospectively rated insurance is an example of such an approach. Here a contractual formula,[27] dependent on actual losses, will

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absorb without help, arising from perils either too profitable or impossible to avoid." R. Mehr & B. Hedges, Risk Management: Concepts and Applications 183 (1974). "[T]here are only four reasons to buy insurance: only if it's legally required, only if you want an insurer to stand between you and the claimant, only when you need the insurance company's services, and only if it is a catastrophic risk." Business Insurance, How 100 Corporations Manage Their Risks and Buy Their Insurance 11 (S. Alt ed. 1976).

24. For example, the total volume of medical malpractice premiums accounted for approximately 0.64% of the total premium income of United States insurers for 1975. Insurance Information Inst., [1976] Insurance Facts Property Liability Marine Surety 11. The rising frequency of medical malpractice claims and the ever larger awards given to claimants have increased this figure to 2% for 1976. *Insurance Premium Distribution,* Best's Rev.—Prop./Casualty Ins. Ed., July 1977, at 11. Unavailability of coverage is a common theme in many liability areas, including lawyers' malpractice insurance. *See, e.g.,* Goldstein, *Lawyers' Malpractice Insurance Rising Steadily as Claims Increase,* N.Y. Times, Feb. 28, 1977, at 1, col. 5.

In summary, existence of a risk of loss is a necessary but not sufficient requirement for an insurance mechanism. In addition, a sufficiently large number of entities must be exposed to the same risk to make it practical to distribute the loss falling upon a few. W. Vance, Handbook on the Law of Insurance § 1, at 5 n.4 (3d ed. 1951).

25. For example, protection from the often devastating consequences of floods is provided through a federal insurance program. *See* 42 U.S.C. §§ 4001-4128 (1970 & Supp. V 1975). One of the reasons for creating the program was that "many factors [had] made it uneconomic for the private insurance industry alone to make flood insurance available to those in need of such protection on reasonable terms and conditions . . . ." *Id.* § 4001(b)(1).

26. For example, the commercial development of nuclear power has been dependent on a limitation in liability for owners and agents for claims arising from a serious nuclear accident. Currently this limitation is $560,000,000. Price-Anderson Act (Atomic Energy Damages) § 4(e), 42 U.S.C. § 2210(e) (1970 & Supp. V 1975).

27. The usual algebraic definition of a retrospectively rated program is: Retrospective premium = [Basic premium + (Standard premium × Excess-loss premium factor × Loss-conversion factor) + (Ratable losses × Loss-conversion factor)] × Tax multiplier, subject to minimum and maximum premium. Basic premium provides for the overhead, assessments, commissions and profit of the insurer. Standard premium is usually developed from a manual review of the traditional exposure indices (*e.g.*, payrolls by labor class for workers' compensation) adjusted by a loss experience modifier. Excess-loss premium factor is multiplied times the

determine the ultimate premium if the calculated value falls within predefined maximum and minimum premiums. If it does not, then one of the bounding premiums will control. Hence, there is, at least conceptually, a transfer of risk arising from two sources: (1) the insurer's obligations to pay losses when they exceed the level consistent with the maximum premium under the contract, and (2) the individual losses, which are totaled to calculate the actual losses in the formula, are truncated at a predetermined maximum (the rating level).[28]

Self-insurance is another financing alternative which has become practical because of the growth in the degree and diversity of liability imposed on corporations. Its use is affected by the nature of the given risk and the size of the corporation. Self-insurance is not simply a euphemism for not buying insurance.[29] It should be an explicit policy of the company to assume an amount of risk in predefined areas, provided that consideration is given to the financial strength of the corporation and the predictability of loss experience. Since insurance premiums are developed with loading factors for the insurer's overhead and profit,[30] it is often more economical for the corporation to assume the risks of such losses than to transfer them to an insurance carrier.

Self-insurance does, of course, have limitations. The amount of loss that a corporation can sustain is a direct function of the amount of variation in its earnings pattern that the company believes would not jeopardize the value of its securities.[31] In a nonprofit organization, such as a municipality or university, there is a similar desire to avoid severe deviations from the budget forecasts for a given fiscal period.

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standard premium for the protection of limiting the individual size of ratable losses to a maximum value. Ratable losses is the summation of all incurred losses assignable to the policy term but individually truncated at the given maximum. The loss-conversion factor represents the cost of claim administration. Finally, the tax multiplier reflects the cost of premium taxes imposed by the various states. *See* R. Mehr & E. Cammack, Principles of Insurance 613-15 (6th ed. 1976). The precise form of the equation will vary because of insurance company policy and state regulatory permission.

28. *Id. See also* M. Greene, Risk and Insurance 655 n.8 (3d ed. 1973).

29. *See* note 5 *supra.*

30. While some lines of insurance display loss costs as high as 90% of premiums (*e.g.*, hospitalization coverages), for the typical casualty lines (*e.g.*, automobile liability) the payments to claimants are only 60% of the total premium. *See* General Insurance, *supra* note 2, at 32-33. The self-insurer, however, must absorb the expense of claim administration, loss control, and state assessments. The extra costs of an insurer (not duplicated in some manner in a self-insured program) usually represent 15% to 20% of premiums. Examples of such costs are state premium taxes, acquisition expenses, commissions, and insurer profits. R. McRell, Self Insurance and Captive Subsidiary Concepts 8 (1973).

31. The relationship between earning fluctuations and security prices has been the subject of some pioneering statistical work. The theory and its empirical support is contained in Markowitz, *Portfolio Selection,* in Security Evaluation and Portfolio Analysis 407 (1972). Financial analysts often use a five-percent variation in pretax earnings as a convenient index of materiality. Such rules of thumb, however, must be cautiously used to avoid misconceptions. For a brief discussion of the materiality concept and the limitations in its application, see D. Kieso & J. Weygandt, Intermediate Accounting 34-36, 122 (2d ed. 1977); E. Kohler, A Dictionary for Accountants 307-08 (5th ed. 1975).

The trust is another vehicle for the prefunding of self-retained risk. A trust may be a particularly useful device for such purposes where intended for the settlement of claims arising from a clearly identifiable group of claimants; where maintaining direct control of claim reserves is not essential; and where the capitalization, administration, and overhead expenses of forming an insurance subsidiary are not justified. The use of trusts has been especially widespread in certain employee benefit areas such as long-term disability and medical services.[32] The trust not only provides protection to the beneficiaries, but it also results in financial benefits to the corporation arising from the tax-exempt status of investment earnings[33] and the reduction or elimination of premium taxes, commissions, and underwriters' profits.[34]

The ultimate conceptual step in the establishment of programs for corporate self-retention of risk is the creation of a wholly owned captive insurance company.[35] The creation of a captive is a formalization of the self-insurance concept. To be granted bona fide status as an insurer, a captive must be an entity that is independent from its parent corporation. It must have a separate management that deals at arm's length with the parent. Finally, it must, like any other conventional insurance company, set premium rates consistent with a profit-making motive and use its energies to reduce the losses that it insures.[36]

Many insurance companies have started their operations as a captive and have subsequently expanded to accept the risks of unrelated corporations or individuals.[37] As a practical matter, therefore, creating a captive may be the first step in the formation of a conventional insurance facility.[38]

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32. *See* LeRoux, *Use of Trusts for Self-Insured Benefits Gets Double Boost*, Bus. Ins., June 2, 1975, at 1, col. 3.

33. This favorable tax treatment is achieved if the plan satisfies the statutory description: "Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual." I.R.C. § 501(c)(9).

34. LeRoux, *supra* note 32, at 1, col. 5.

35. *See* note 7 *supra*.

36. *See* H. New, The Captive Insurance Company (1973); Goshay, *Captive Insurance Companies*, in Risk Management 80-85 (H. Snider ed. 1964). Although the IRS has espoused a policy against the treatment of captives as legitimate insurance companies under the Code, *see* pt. III(D)(2) *infra*, a recent study sponsored by the U.S. Department of Commerce has endorsed the formation of captives as one means of solving the products liability crisis. *See* The Research Group, *Captive Insurance Companies*, in Risk Management and Self-Insuring for Product Liability Claims: Defense Planning 339 (M. Hoenig chairman 1977).

37. Developing some significant third-party business may be of substantial aid in obtaining favorable treatment from the Internal Revenue Service regarding the deductibility of premiums paid to a captive. LeRoux, *Ford Motor Skirmish with IRS Over Captive Is Landmark Case*, Bus. Ins., Dec. 1, 1975, at 1, col. 3; Saggese, *Utilization of a Foreign Captive Insurance Corporation*, 1976 Ins. L.J. 525, 528-29. This mode of operation has been characterized as the "new" captives. Kloman, *Captive Insurance Companies—1976*, 3 Risk Management Rep. No. 1, 12, 16 (Jan. 1976).

38. This progression has been noted as part of the life cycle of many insurance companies. Goshay, *Captive Insurance Companies*, in Risk Management 85-86 (H. Snider ed. 1964).

Currently, there is a debate as to the appropriate tax and accounting conventions which should be applied to captives.[39] Complicating this debate is the fact that the term "captive" is applied to a broad spectrum of risk accepting operations.[40] Such imprecision in terminology means that unqualified statements about the tax or accounting treatment of captive insurance companies are quite suspect. For example, a captive that exclusively writes the risks of the parent is in a weaker position to claim the status of an insurance company than one which, although primarily insuring the risks of the parent, also actively solicits and retains risks of unrelated parties. In reviewing these conflicting positions, the reader should note that the factual aspects of a given program are as important as its formal structure in predicting the ultimate income tax treatment.

II. The Income Tax Treatment of Contingencies

The income tax treatment of the various financing plans for self-assumption of risk is closely related to the more general controversy regarding the deductibility of contingent liabilities, which arose nearly simultaneously with the advent of the federal income tax system.[41] While income tax accounting procedures for liabilities settled and paid during the tax year are relatively straightforward,[42] contingent or contested liabilities raise complex tax issues under accrual accounting procedures. The vast majority of financially significant corporations use accrual accounting procedures.[43] In such instances, the tax treatment of contingencies has not been developed through statutory

39. The debate arises because substantial income tax deferral can occur in a captive plan, which thus provides the corporate taxpayer with a financial incentive to pursue such plans despite IRS opposition. *See generally* text accompanying notes 199-210 *infra*. Recently the IRS added fuel to this debate by denying a parent corporation a tax deduction for insurance premiums paid to its foreign captive. Rev. Rul. 77-316, 1977-35 I.R.B. 7. The action has sparked wide industry comment. *See, e.g.*, Roberts, *IRS Axes Deduction for Premiums Paid to Captives; Court Test Awaited*, Bus. Ins., Sept. 19, 1977, at 1, col. 1.

40. *See* note 7 *supra*.

41. United States v. Anderson, 269 U.S. 422 (1926), a major case in this area, was decided by the Supreme Court only thirteen years after the passage of the federal income tax law in 1913. The Board of Tax Appeals confronted the issue of the deductibility of reserves for self-insured losses for tax years prior to 1920. *See* notes 150-57 *infra* and accompanying text.

42. These are generally deductible under either I.R.C. § 162 as a trade or business expense (provided they meet the "ordinary and necessary" requirement) or I.R.C. § 165 as a loss (provided the taxpayer is not otherwise compensated).

43. Under an accrual method, income is recognized (or a liability deducted) in the taxable year when all the events have occured which fix the right to receive such income (or establish the fact of liability) and the amount thereof can be determined with reasonable accuracy. A cash system, in contrast, recognizes income when actually or constructively received and permits deductions only when expenditures are actually made. Treas. Reg. § 1.446-1(c)(1)(i), (ii) (1973). The Code specifically permits a taxpayer to use either a cash or an accrual system. However, he generally must use the same method for both reporting and determining taxable income. I.R.C. § 446(a), (c). Unfortunately, these straightforward concepts of accrual and cash basis systems can become quite complex when subjected to Internal Revenue interpretation. *See* 2 J. Mertens, The Law of Federal Income Taxation § 12.03 (1974).

or administrative methods, but has instead emerged from case law.[44] Hence, this section will focus on the precedential value of these judicial decisions as applied to the four financing methods discussed above.

A. *The Development of the "All Events" Test*

The "all events" test was developed in *United States v. Anderson.*[45] There the taxpayer unsuccessfully attempted to defer a deduction for a federal profits tax which had accrued, but which was not required to be paid until the next year. The Court set forth two criteria for the deduction of expenses by an accrual basis taxpayer:

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which *fix the amount* of the tax and *determine the liability* of the taxpayer to pay it.[46]

These two key phrases have engendered a plethora of often conflicting cases which have attempted to apply the test to concrete situations.[47]

The first requirement, namely, that the amount be fixed, concerns the ability of the taxpayer to estimate adequately the amount of liability or expense which has allegedly been incurred during the tax year in question. While the debate in this area concentrates on what constitutes "reasonable accuracy" as required by the Treasury Regulations,[48] the courts have displayed some flexibility in determining compliance with the estimation standard.[49]

The other element in the necessary equation is to "determine the liability," of the taxpayer which effectively demands the absence of a contingency in the expense. This latter requirement has historically been the greater stumbling block to an allowable deduction.[50] The policy behind prohibiting deductions for contested liabilities is the desire to prevent abuses by taxpayers taking deductions for expenses that might never occur.[51] While this concern can

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44. Oshatz, *Accrual and Deductions of Contested and Contingent Liabilities*, 26 N.Y.U. Inst. Fed. Tax. 747, 749 (1968) [hereinafter cited as *Contingent Liabilities*].

45. 269 U.S. 422 (1926).

46. *Id.* at 441 (emphasis added).

47. J. Chommie, The Law of Federal Income Taxation § 83, at 236-37 (2d ed. 1973). The cases are conveniently collected in 2 J. Mertens, *supra* note 43, § 12.61.

48. *See* Treas. Reg. § 1.461-1(a)(2) (1967).

49. *See* pt. II(C) *infra.*

50. The estimation requirement is largely a factual question, the determination of which has been made easier by modern statistical methods. Indeed, courts have demonstrated a willingness to accept such statistics. "A number of cases . . . indicate that there is a trend among the courts to permit the accrual of expenses when the liability is certain and the amount although not precisely determinable is susceptible to reasonable estimate." 2 J. Mertens, *supra* note 43, § 12.61, at 232 (footnote omitted).

51. *See, e.g.*, Mooney Aircraft, Inc. v. United States, 420 F.2d 400, 406 (5th Cir 1969) (citing Note, *Accrual Accounting and the Clear Reflection of Income: Purity of Accounting Principles Forsaken for the Protection of Tax Revenues*, 42 Notre Dame Law. 511, 520 (1967)).

hardly be challenged, its implementation sometimes achieves a more restrictive result than necessary.

B. *The Determination of Liability*

The large body of case law does not provide a clear standard for ascertaining whether or not liability has been determined. An examination of the cases reveals, however, that four distinct considerations are consistently utilized to determine the issue: (1) whether the liability is being actively contested by the taxpayer, as for example, by litigating the issue; (2) whether the liability arises by virtue of law or by contract; (3) whether the deduction for the liability fairly reflects financial performance in light of the taxpayer's integrated accounting system; and (4) whether there is an unreasonable delay between the occurrence of the liability and the time the obligation actually becomes due.

1. Actively Contested

The difficulties in demonstrating that the liability is determined are exemplified in *Lucas v. American Code Co.*[52] In that case, a corporation had breached an employment contract with its sales manager and the issue was whether the corporation could deduct the resulting anticipated damages even though the case was still in litigation. Since such deductions would, at least in the short term, reduce taxable income,[53] it is perhaps not surprising that the Supreme Court required more of the taxpayer corporation than simply the ability to estimate accurately the unpaid liability. The touchstone employed by the Court was whether or not the taxpayer was actively contesting his liability. As stated by the Court:

> [A] loss occasioned by the taxpayer's breach of contract is not deductible in the year of the breach, except under the special circumstances where, within the tax year, there is a definite admission of liabilty [*sic*], negotiations for settlement are begun, and a reasonable estimate of the amount of the loss is accrued on the books.[54]

In Dixie Pine Products Co. v. Commissioner,[55] the Court reaffirmed the basic requirement that income tax accrual demands the existence of an uncontested liability. Nevertheless, the treatment of the case exemplified a policy of permitting the deduction where the accrual basis taxpayer has actually paid the liability that he is contesting. *Dixie Pine* involved a

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52. 280 U.S. 445 (1930).

53. The damages for the corporate taxpayer's breach of contract, presumably, would be deductible if actually paid. Thus, the real impact of accrual basis deductions on the Treasury comes from the accelerated timing—not the absolute size—of the deductions. A Code provision, Int. Rev. Code of 1954, ch.1, § 462, 68A Stat. 158 (1954) (repealed 1955), which would have significantly liberalized the rules for the deduction of future estimated expenses, was repealed retroactively largely because of the anticipated degree of revenue loss. 2 J. Mertens, *supra* note 43, § 12.22c.

54. 280 U.S. at 450 (footnote omitted).

55. 320 U.S. 516 (1944).

Mississippi taxing authority which had declared that a solvent used by petitioner was within the statutory definition of gasoline and hence subject to state tax. After paying the tax for 1936, petitioner brought suit challenging the state's action.[56] In 1937 the taxpayer accrued the expense for the contested tax, but did not actually pay it. As to this latter year, the Court determined that the standard for accrual deduction had not been met.[57] It is significant that the federal tax authorities did not challenge the validity of the deduction for 1936, nor was this treatment questioned by the Court.

A contrary position was taken in *United States v. Consolidated Edison Co.*[58] where the taxpayer was not permitted to accrue a contested tax which had been paid to New York City authorities in order to avoid seizure of property involved. The Court determined that a contested tax liability did not accrue as a deduction in the year the tax was paid under protest. Despite payment, the deduction had to be deferred to the year when the litigation was finally terminated.[59] Because many accrual basis taxpayers would have been adversely affected by the application of this decision's logic,[60] Congress adopted section 461(f) of the Internal Revenue Code of 1954[61] which overruled the decision's result, but not its reasoning. While the statute removes an undue burden upon the taxpayer using accrual accounting, the exception provided by the statute has limited business applications. One obvious disadvantage is that the contested property must be placed outside corporate control. The statute does, however, leave open the possibility of paying such liabilities to a related party such as a trust.[62]

2. Determination of Liability by Contractual or Statutory Obligation

The requirement of a determined liability may also be satisfied by reason of duties imposed by law. In *Harrold v. Commissioner,*[63] the Fourth Circuit permitted a deduction for the cost of land rehabilitation made necessary by the strip mining operations of the taxpayer. This program was required by state environmental regulations, and the obligation was secured by a performance bond. From these facts, the Court determined that the taxpayer had incurred a definite liability. Its opinion reiterated the rule that:

56. *Id.* at 517.

57. *Id.* at 519.

58. 366 U.S. 380 (1961).

59. *Id.* at 391-92. This issue had not been raised in *Dixie Pine* because the challenged deduction was an accrual made even though the taxpayer had not paid the contested gasoline tax.

60. *Contingent Liabilities, supra* note 44, at 762.

61. Section 461(f) provides: "If—(1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year), then the deduction shall be allowed for the taxable year of the transfer."

62. *See* pt. III(C) *infra*.

63. 192 F.2d 1002 (4th Cir. 1951). *See also* Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959).

[w]hen all the facts have occurred which determine that the taxpayer has incurred a liability in the tax year, and neither the fact nor the amount of the liability is contested, and the amount, although not definitely ascertained, is susceptible of estimate with reasonable accuracy in the tax year, deduction thereof from income may be taken by a taxpayer on an accrual basis.[64]

With regard to contractual liabilities, the parties may exercise some control over the income tax consequences. While the requirement of definite liability remains, *Gillis v. United States*[65] represents the proposition that inquiry may also be made into the substance of the transaction to determine whether in fact liability is contested. In *Gillis,* the taxpayer knew that he had violated a contractual agreement by shipping cotton of substandard quality. While the claims had to be settled by means of arbitration, the court found that such procedures "[were] not as adversative as usual litigation" and that, furthermore, these claims were "anticipated and [were] in the norm of the trade."[66]

The Fifth Circuit allowed deduction of the liability for the claim expected to be asserted pursuant to the export cotton contract. Since a deduction was allowed on the basis of the loss event itself, prior to the manifesting claim, the decision can be considered as an expansion of the standard for determining liability.[67]

3. Integral Accounting Rule

The Internal Revenue Code explicitly grants the Commissioner discretion to reject a taxpayer's accounting system when that system does not clearly reflect income.[68] The fact that a given convention is viewed favorably by generally accepted accounting principles does not necessarily result in acceptance by the Commissioner for tax accounting purposes.[69] The implications of such flexibility are illustrated by *Schlude v. Commissioner,*[70] where a hus-

64. 192 F.2d at 1006. The legal obligation must be incurred by virtue of performing the given activity. The distinction is illustrated by the denial of a deduction to an airline which attempted to accrue the periodic costs of airplane maintenance ratably with the in-service hours between mandatory inspections. The deduction was denied because this equipment maintenance program was required only for future flight operation. Unlike the land rehabilitation case, the operation of the airplane did not give rise to an absolute responsibility to perform the inspections in the future. World Airways, Inc. v. Commissioner, 62 T.C. 786 (1974), *appeal docketed,* No. 75-2176 (9th Cir. May 23, 1975).

65. 402 F.2d 501 (5th Cir. 1968).

66. *Id.* at 509.

67. The expansive position of the Fifth Circuit has not been maintained. In Trinity Constr. Co. v. United States, 424 F.2d 302 (5th Cir. 1970), a deduction was denied because payment was dependent on a condition subsequent. *See* notes 104-08 *infra* and accompanying text.

68. I.R.C. § 446(b).

69. *See, e.g.,* Eastman Kodak Co. v. United States, 534 F.2d 252, 255-56 (Ct. Cl. 1976). For convenience, this flexibility to evaluate a taxpayer's financial position notwithstanding generally accepted accounting principles is referred to as the integral accounting rule.

70. 372 U.S. 128 (1963) (5 to 4 decision). Note that the issue in *Schlude* was whether or not income actually received may be deferred recognition to some subsequent time period. The Treasury Service has traditionally been quite reluctant to permit such deferral despite a host of

band and wife operated a franchised dance studio. Contracts provided that the students had a fixed obligation to pay for their lessons without any right to refund or cancellation.[71] The taxpayer sought acceptance of a tax accounting system whereby he considered as "earned income" only that portion of the total contract price relating to the lessons actually given during the tax year. The Court disagreed and required that the total tuition received be treated as income. One factor in the Court's decision was that the royalty payments and sales commissions were deducted when paid irrespective of the period in which related receipts were taken into income.[72] It may be argued that the Court rejected the accounting convention because it would have delayed recognition of income in combination with an inconsistent treatment of related expenses.[73] The taxpayer's accounting method was, however, permitted by generally accepted accounting principles.[74]

In *Pacific Grape Products Co. v. Commissioner*,[75] the Ninth Circuit allowed the taxpayer to accrue the expenses anticipated for shipping costs and brokerage fees on unshipped fruit products. The decision turned on the particular accounting procedures of the company, which recognized as income the unreceived sales price of such products. Also significant were the determinations that title to the unshipped goods had passed to the buyers and that the particular system of accounting utilized by the taxpayer was common in its industry.[76]

A case indicating the multiplicity of considerations involved in the typical tax decision is *Schuessler v. Commissioner*.[77] There the taxpayer sold furnaces on which he included a five-year service contract. He was permitted to exclude from income that portion of the sales price which related to the anticipated costs of performing those services.[78] While the Supreme Court's subsequent decision in *Schlude*[79] established a broad rule requiring early

taxpayer's arguments. J. Chommie, The Law of Federal Income Taxation § 83, at 240 (2d ed. 1973). One basis for the Supreme Court's restrictive stance on the allocation of income is the short lifetime of Int. Rev. Code of 1954, ch.1, § 452, 68A Stat. 152 (1954) (repealed 1955), which would have permitted such deferrals. *See* B. Bittker & L. Stone, Federal Income Estate and Gift Taxation 836-39 (4th ed. 1972); Chommie, *supra* at 247.

71. 372 U.S. at 130.

72. *Id.* at 132.

73. *Id.* at 136.

74. *Id.* at 132.

75. 219 F.2d 862 (9th Cir. 1955).

76. *Id.* at 867-68.

77. 230 F.2d 722 (5th Cir. 1956).

78. *Id.* at 725.

79. *See* text accompanying notes 70-74 *supra*. There has been a marked disparity between the expansive theories requiring early recognition of income and the restrictive concepts used to deny a current deduction for allegedly uncertain expenses. *Compare Schlude with* American Auto. Ass'n v. United States, 367 U.S. 687 (1961).

The distinction has a long history in the interpretation of the tax law. "The power to tax income . . . is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed." New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

recognition of income, two considerations may sufficiently distinguish *Schuessler* so that it retains its vitality:[80] (1) the price for the taxpayer's furnaces was inflated to reflect the cost of the additional maintenance services and (2) the maintenance obligation was less contingent than the requirement to provide future dance lessons, that is, no affirmative act of the buyer was needed to trigger the future service.

The approach of *Schuessler* has direct application to the deductibility of self-insurance reserves for liabilities developed on a no-fault standard[81] and asserted during the tax year in issue. However, the absence of a fixed future responsibility, such as that in *Schuessler,* would be a substantial barrier to permissible income tax accrual despite the taxpayer's contention that such treatment is required to match income and expense.

4. Remote in Time

Even given a defined liability, the courts are unlikely to permit a deduction when the actual payment will be made at a "remote" point in time. In *Mooney Aircraft, Inc. v. United States,*[82] the taxpayer issued bonds of $1,000 face value which were to be honored on the permanent retirement of the airplane it manufactured. The plan was simply an inducement to potential buyers. Although such a bond would seem to meet the "all events" test,[83] a current deduction for the face value of the bonds was disallowed.[84] The Fifth Circuit reasoned that payment was so far removed from the time the obligation was incurred that the IRS was justifiably concerned that permitting the deduction would subvert the fundamental principle of accrual accounting that expenses be matched against income.[85]

C. *The Ability To Fix the Amount of Liability*

The determination of an acceptable standard for "reasonable accuracy" is the second fundamental test in determining the success of an attempted deduction. In *Brown v. Helvering,*[86] the taxpayer raised an important issue concerning the standard for estimation when a deduction is sought for the collective result of a large number of individual events. The question was whether the estimation accuracy is to be judged on an individual event basis or on a single aggregate standard. This distinction has particular significance

80. *But cf.* B. Bittker & L. Stone, Federal Income Estate and Gift Taxation 840 (4th ed. 1972) (the authors conclude that the status of the case is currently unclear).

81. *See* notes 159-65 *infra* and accompanying text.

82. 420 F.2d 400 (5th Cir. 1969).

83. *See* text accompanying notes 45-50 *supra.*

84. 420 F.2d at 409-10.

85. *Id.* at 410. *See generally* 10 Fed. Tax Coordinator 2d ¶G-2600 (Research Inst. of America) (Apr. 1977) (*Mooney* is discussed as an exception to the usual rule). One analysis of the decisions involving the current accrual of expenses to be paid in the future has noted their conflicting results. *See* [1977] 3 Fed. Taxes (P-H) ¶20,577. Thus the IRS challenge is like a double-barreled shotgun: it can either deny the deduction because the conditions do not qualify under the "all events" test or because of the bar against deferral of prepaid income. *Id.*

86. 291 U.S. 193 (1934).

to corporate risks (particularly for workers' compensation and automobile liability) where annual claim counts measured in hundreds are commonplace. In such instances, the attempted deduction represents the estimated costs of a large number of individual and essentially independent claims. Obviously, a standard based on aggregate results would be more easily met, thus permitting a tax deduction if the determination of liability requirement was also met.[87]

In *Brown,* the individual unit was the potential refund of commissions already received from the sale of individual insurance policies.[88] The taxpayer did not claim an ability to identify which particular policies would be prematurely cancelled. He argued instead that he could reasonably estimate the collective impact of cancellations from the much larger number of policies written in a given year. Rejecting this argument, the Court clearly distinguished the standard for evaluating a similar deduction sought by an insurance company.[89] The general rule is that the non-insurance company taxpayer must comply with the "all events" test on the most elementary level. An insurance company, on the other hand, is taxed under subchapter L of the Internal Revenue Code and is permitted to analyze its operations on a group basis.

There are substantial ramifications arising from the *Brown* doctrine which can bar superior tax treatment in terms of matching income and expense. In *American Automobile Association v. United States,*[90] the taxpayer argued for a deferral of income received in advance from members for services to be rendered during their period of membership. The accrual basis taxpayer allocated dues over the membership period by using statistical methods developed from experience. The methods were designed to match the monthly incurred costs with the income from the membership dues. The Court was unswayed by this statistical evidence, in part because it was based on the performance of the membership in the aggregate.[91] The fact that the costs attributable to the service demands of any specific individual member could not be estimated accurately was determinative for the Court.

Estimation techniques were also involved in *Milwaukee & Suburban Transport Corp. v. Commissioner.*[92] The earlier tax court decision had rejected the accrual of incurred liabilities in part because the "reasonable certainty" standard for estimation had not been met. To support its conclusion the court had reviewed individual claims comparing the initial estimated

87. That the aggregate performance of a large number of independent events can be more accurately estimated than any single event is a reexpression of the "law of large numbers" which underlies insurance ratemaking. *See* R. Mehr & B. Hedges, Risk Management in the Business Enterprise 108-20 (1963).

88. 291 U.S. at 195. For a discussion of this case, see notes 146-49 *infra* and accompanying text.

89. 291 U.S. at 201.

90. 367 U.S. 687 (1961).

91. *Id.* at 693.

92. 18 T.C.M. (CCH) 1039 (1959), *rev'd,* 283 F.2d 279 (7th Cir. 1960), *vacated per curiam,* 367 U.S. 906, *aff'd,* 293 F.2d 628 (7th Cir. 1961), *cert. denied,* 368 U.S. 976 (1962).

cost with the ultimate settlement cost. "Settlements were at variance with estimates by more than 100 per cent in 97 of [the claims which occurred in 1953] and in 102 of [the claims which occurred in 1954]."[93] The Seventh Circuit,[94] in overruling the Tax Court, permitted the deduction because it found that the taxpayer had demonstrated an ability to estimate with reasonable accuracy the collective performance of all claims.[95] The Court of Appeals apparently believed that if aggregate performance was predictable, then errors in the individual estimates, highlighted by the Tax Court, were irrelevant. The validity of this approach, however, was implicitly rejected when the Supreme Court vacated the decision.[96]

A further complication often involved in these cases is the relationship between deductibility and conditions subsequent—those events whose future occurrence would terminate an existing liability. Not all courts have addressed the issue, and when it has been raised, conflicting opinions have often resulted. As discussed below, this factor is often considered as one part of the standard for judging the ability to make a reasonable estimate of liability.

In *Wien Consolidated Airlines, Inc. v. Commissioner,*[97] the Tax Court found that when a company pilot was killed in an airline crash all events had occurred which were necessary to create a definite liability for workers' compensation benefits provided that the company was not contesting its liability.[98] However, because the corporation's statutory obligation to the pilot's spouse ended with remarriage or death, payments owed to the widow were held to be incapable of estimation with "reasonable certainty" since the contingency of remarriage had substantial probability of occurrence and yet could not be predicted in any individual case.[99] The significance of this aspect of the opinion is unclear because the court refused to rule on whether

93. 18 T.C.M. (CCH) 1039, 1048 (1959). These statistics were from a total claim population of approximately 400 a year.

94. 283 F.2d 279 (7th Cir. 1960).

95. *Id.* at 286-87.

96. 367 U.S. 906 (1961). The argument that estimates of ultimate liability should be judged on an aggregate basis was squarely confronted and rejected by the Tax Court. 18 T.C.M. (CCH) 1039, 1050-51 (1959) (citing Brown v. Helvering, 291 U.S. 193 (1934)). The court found the taxpayer's reliance on Ocean Accident & Guar. Corp. v. Commissioner, 47 F.2d 582 (2d Cir. 1931), and Pacific Empl. Ins. Co. v. Commissioner, 33 B.T.A. 501 (1935), misplaced because Milwaukee, unlike the taxpayers involved in these cases. did not have the status of an insurance company. 18 T.C.M. (CCH) at 1050-51.

Although it is submitted that the proper standard of estimation should be the aggregate standard, the Tax Court has continued to require reasonable accuracy on a case-by-case basis. For a recent opinion so holding, see Gateway Transp. Co. v. United States, 77-1 U.S. Tax Cas. ¶9131 (W.D. Wis. 1976) (involving deduction of a reserve for bill of lading losses arising from taxpayer's freight carriage activity).

97. 60 T.C. 13 (1973), *aff'd,* 528 F.2d 735 (9th Cir. 1976).

98. As far as permitting a deduction for reserves associated with uncontested workers' compensation claims, the case follows Crescent Wharf & Whse. Co. v. Commissioner, 518 F.2d 772 (9th Cir. 1975). The implications of such a standard for determining liability are discussed in notes 158-68 *infra* and accompanying text.

99. 60 T.C. at 17.

"statistics on remarriage would have established the amount of the liability"[100] had they been available. The Ninth Circuit's affirmance seemed to indicate that such statistics could have saved Wien's current deduction for the future benefits due the spouse. "By being unable to present any evidence on the probability of remarriage, Wien failed to sustain its burden of proving the amount of liability with reasonable accuracy."[101]

A different result was reached with regard to the dependent children. In their case the taxpayer was permitted to accrue the full liability on the basis of the years remaining until they were nineteen. The contingency of intervening death was judged so unlikely that it did not bar determination of the amount to be accrued.[102] Thus, liability to the children was immediately deductible, while the liability to the widow was deductible only as paid.

The Ninth Circuit's reasoning in *Wien* may be analyzed by focusing on the nature of a condition subsequent as opposed to a condition precedent. The latter must be met as part of the "all events" test, requiring that a tax deduction must represent a determined liability.[103] By definition, the former are events which terminate an *existing* liability. As such, the existence of conditions subsequent should not automatically bar a current tax deduction. The Ninth Circuit's evaluation appears to be a good compromise. Its standard would permit a current deduction despite a condition subsequent to liability, if the taxpayer can prove the ability to estimate with reasonable accuracy.

This approach is different from that of the Fifth Circuit's holding in *Trinity Construction Co. v. United States.*[104] In *Trinity* the taxpayer was obligated to pay life insurance premiums on the lives of two key employees for a period of ten years.[105] After making four annual payments the taxpayer, which was about to merge with another company, created a trust with an amount sufficient to pay the remaining six premium payments. This full amount was taken as a deduction on its final income tax return.[106] The Fifth Circuit disallowed the deduction, asserting that the determination of liability part of the "all events"[107] test had not been met because the payments were contingent on "[the employees] being alive at the due date of each of those remaining installments."[108] Thus, the court made no inquiry into the taxpayer's ability to

100. *Id.*

101. 528 F.2d 735, 738 (9th Cir. 1976) (footnote omitted).

102. *Id.* at 738.

103. *See* pt. II(B) *supra.*

104. 424 F.2d 302 (5th Cir. 1970).

105. *Id.* at 304.

106. *Id.* Note that in *Trinity* the tax year involved was the fiscal year which ended February 28, 1959. *Id.* at 303. Thus, I.R.C. § 461(f) (quoted in note 61 *supra*) was not discussed since that section was not adopted until 1964. For a review of the use of trusts to achieve the kind of deduction sought in *Trinity,* see pt. III(C) *infra.*

107. *See* pt. II(B) *supra.*

108. 424 F.2d at 305. The Tax Court's decision in *Wien* had distinguished *Trinity* on the basis that Wien owed a lump-sum amount to the minor dependents whereas Trinity was only required to pay the insurance premium annually when due. It concluded that the latter arrangement made the continuing life of the insured a condition precedent, not a condition

estimate the ultimate insurance premiums. This conflict between the circuits will have to await resolution by the Supreme Court.[109]

The above cases illustrate both the difficulties encountered in defining "reasonable accuracy" for fixing the amount of liability and the need for better means of providing taxpayers with some guidance as to an acceptable standard. It is submitted that if a taxpayer can demonstrate that the "liability is fixed" in accordance with the standards reviewed above, then the only proper manner to judge the "reasonable certainty" in estimation is on the aggregate performance of the cases or claims involved.[110] The possibility that a condition subsequent could extinguish an existing liability should be treated merely as one factor in judging compliance with this estimation standard—not as an absolute bar to deductibility. With such ground rules, a reasonable standard of estimation should be within twenty percent of the ultimate value.[111] Such a guideline would serve to restrict abuses and yet would not bar justified income tax deductions.

III. Income Tax Implications of Alternative Risk Financing Methods

Some degree of self-assumption of risk is normal for the large corporation. The principal alternatives available for the financial management of such responsibilities can be classified as: (1) retrospectively rated insurance, (2) self-insurance programs, (3) the establishment of a trust with claimants as beneficiaries, and (4) the creation of a captive insurance company.[112] The income tax consequences of these four financing alternatives are discussed in appropriate detail in the following subsections.

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subsequent, to liability. 60 T.C. 13, 15 (1973). The Ninth Circuit affirmed the *Wien* decision, but it was explicit in its rejection of the reasoning in *Trinity*. *See* 528 F.2d 735, 738 n.5 (9th Cir. 1976).

109. 3 Tax Coordinator (Tax Research Inst. of Am.) ¶G-2604, at 25,036 (Oct. 21, 1976).

110. *See* American Auto. Ass'n v. United States, 367 U.S. 687, 714-16 (1961) (Stewart, J., dissenting).

111. In Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951) (involving accrual for land rehabilitation following strip mining), the court recognized that "it has not been deemed essential that the amount of an accrued liability shall have been definitely ascertained to justify deduction from income in the taxable year." *Id.* at 1004. After strip mining approximately 31 acres, the taxpayer had accrued $31,090 for anticipated back-filling expense. When the operation was completed the actual resulting cost was $25,210.18. *Id.* at 1003. This computes to a percentage difference of: ($5,879.82/$31,090) × 100% = 18.9%. The aggregate statistics in Milwaukee & Suburban Trans. Corp. v. Commissioner, 283 F.2d 279 (7th Cir. 1960), *vacated per curiam,* 367 U.S. 906, *aff'd,* 293 F.2d 628 (7th Cir. 1961), *cert. denied,* 368 U.S. 976 (1962), which the circuit court found acceptable, were for 1953: (($192,730.24-$254,659.00) ÷ $254,659) × 100% = −24.3%; for 1954: (($211,266.84-$161,136.50) ÷ $161,136.50) × 100% = 31.1%. In Crescent Wharf & Whse. Co. v. Commissioner, 518 F.2d 772 (9th Cir. 1975) (accruals for workmen's compensation liabilities), the taxpayer indicated that aggregate estimates of ultimate liability had been within 10.65% of the actual figures. Brief for Appellant at 8.

112. For a brief discussion of these alternatives, see pt. I(C) *supra*.

A. *The Insured Alternative*

Of the alternative financial plans considered, the payment of premiums to a third-party insurer offers the least difficulty in determining its tax consequences. In general, such payments are deductible as a business expense.[113] Given this treatment, it follows that claim payments made by the insured are not deductible to the extent they are covered by the insurance contract.[114] When the premium is paid for a coverage period longer than a single year, generally accepted accrual accounting principles limit the allowed deduction to the pro-rata amount applicable to the respective years.[115]

Major corporations with large random hazard loss exposures can often tolerate a potential variation in their operating costs by self-assuming a portion of such risks. When corporations purchase insurance within such levels, they often do so as a means of acquiring necessary services (such as claims administration, statistical reports, and loss engineering)[116] and of complying with statutory or contractual requirements.[117] Such considerations, together with the insurer's desire to minimize its risk, can be mutually satisfied by the use of retrospectively rated insurance.[118] Policies based upon this concept are now used across the broad spectrum of casualty risks.[119]

Because, under a retrospectively rated policy, several years often elapse before the ultimate premium for a given policy year can be determined,[120] there is some doubt about the right of the corporation to deduct the amount of

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113. *See* I.R.C. § 162. "Among the items included in business expenses are . . . insurance premiums against fire, storm, theft, accident, or other similar losses . . . ." Treas. Reg. § 1.162-1(a) (1975). The multiplicity of corporate risk exposure has produced over one hundred types of specific policies. For a list of these policy types, see 4A J. Mertens, *supra* note 43, § 25.101 (1972).

114. Only the net amount of the loss is deductible. 5 J. Mertens, *supra* note 43, § 28.07 (1975). The burden of proof is on the taxpayer as deductions are not a matter of right but of legislative grace. *Id.* § 28.03.

115. 1 Am. Inst. of Certified Pub. Accountants, APB Accounting Principles § 1026.23 (1973). These accounting limitations would also prevent the deduction of such prepayments for federal income tax purposes. *See* I.R.C. § 461.

116. The emerging concept of a risk management philosophy captures this logic and is exemplified by the following statement: "It is our general practice to retain risks up to $_____ per loss and insure them above these amounts. . . . Exceptions are made when it is desirable to buy special insurance services such as loss prevention or claims adjustment." 1 M. Lenz, Risk Management Manual, Introduction—Basic Concepts 6 (1971) (quoting Christy, *Alertness to Changing Needs,* in The Growing Job of Risk Management 57 (1962)).

117. *Id.* § 6, Insurance 3.

118. *See* notes 27-28 *supra* and accompanying text.

119. C. Kulp & J. Hall, Casualty Insurance 935-51 (4th ed. 1968).

120. The premiums of such policies will ultimately be determined by the corporation's own loss experience together with provisions for the service fees, claims administration expense, overhead, and profit of the insurance company. *See* note 27 *supra* and accompanying text. The contract will often specify that the retrospective premiums are to be computed at defined intervals, *e.g.*, by using the losses valued as of 6 months, 18 months, or some other time period from the end of the policy year. Erickson, *Retrospective Rating*, in 1 M. Lenz, Risk Management Manual § 6, Insurance 131, 152-53 (1975) (Supp. No. 21).

the deposit (commonly referred to as a deposit premium) paid during the first year of the program.[121] This uncertainty also applies to the intermediate retrospective premium adjustments made at predefined intervals. These are often paid well before all the claims are settled and hence before the ultimate premium is determined.[122] An argument can be made that liability is not defined at the program's inception or at the intermediate valuations because the amount is subject to adjustment based on actual loss experience.[123] Although this argument is valid to the extent that the deposit premium, in conjunction with the intermediate retrospective premium adjustments, exceeds the minimum premium,[124] the IRS has, nevertheless, generally allowed such premiums to be fully accrued as expenses. There are, however, few decisions to support IRS policy. One commentator has concluded that a deduction is allowed "because an expense is properly deductible despite a *contingent* possibility of reimbursement in the future."[125] The question of the timing of these expense deductions was discussed in *Midwest Motor Express, Inc. v. Commissioner.*[126] There a retrospectively rated insurance policy for automobile liability had been in effect for policy year 1948. In 1950 the company was assessed an additional premium consistent with the contractual formula.[127] The premium adjustment arose from a claim reserve[128] associated with an accident which occurred during 1948 but which was not settled until 1952. The Tax Court held that the deduction should have been taken prior to 1952, because all the events necessary to support the deduction had occurred prior to that time,[129] despite the fact that future events could affect the value of outstanding claims and hence the ultimate premium.[130]

121. The general requirements for a current deduction by an accrual taxpayer are summarized in Treas. Reg. § 1.461-1(a)(2) (1967).

122. Of course, the insurer and insured may agree, for various reasons, to make a final determination for a particular year without waiting for all cases to close. Erickson, *supra* note 120, at 152.

123. The argument arises from cases like Brown v. Helvering, 291 U.S. 193 (1934), *discussed at* notes 88-89 *supra* and accompanying text.

124. Since there would be an absolute obligation to pay the minimum premium, the Treasury Regulations provide a basis for deducting at least that amount. Treas. Reg. § 1.461-1(a)(2) (1967).

125. 3 Tax Coordinator (Tax Research Inst. Am.) ¶G-2604 (Dec. 3, 1970).

126. 27 T.C. 167 (1956), *aff'd on other grounds,* 251 F.2d 405 (8th Cir.), *cert. denied,* 358 U.S. 875 (1958).

127. *Id.* at 179.

128. When a claim is reported to an insurance company, the claims department will make an estimate of the company's ultimate liability. R. Mehr & E. Cammack, Principles of Insurance 560 (6th ed. 1976). The estimate is, of course, subject to future adjustment. At a given point in time the difference between that estimate and the cumulative amount paid is the claim reserve. *See* L. Davids, Dictionary of Insurance 159 (5th ed. 1977) (under definition of "loss reserve"). The standard convention for retrospectively rated policies is to compute the contractual adjustment on the incurred losses assignable to the policy. This adjustment is made at predetermined time intervals after the end of the policy year. *See* discussion note 120 *supra.* Incurred losses are usually defined as the sum of the amounts paid and the claim reserves for cases assignable to the policy year. *See* Davids, *supra* at 159 (under definition of "losses incurred").

129. 27 T.C. at 187.

130. *Id.* at 188.

The corporate tax treatment of the premiums for retrospectively rated insurance policies may be clarified by considering the treatment afforded to the other side of the transaction—the premiums received by the insurance company. Under section 832 of the Internal Revenue Code of 1954, an insurance company may reduce its underwriting income to the extent of "unearned premiums on outstanding business at the end of the preceding taxable year."[131] The Treasury Regulations provide that credits accrued on retrospectively rated policies, that is, instances where favorable loss experience produces a return premium to the insured, can be considered in the calculation of "unearned premiums"[132] even if the credits are not actually paid during the taxable year.

Originally the IRS disallowed this deduction in underwriting income because the insurer's liability to pay the premium credit was dependent on actual loss development. It argued that the contingency of reimbursement meant that the premium credit did not represent a definite liability.[133] If insurance companies were evaluated by the "all events" test[134] imposed on other business corporations,[135] then consistent reasoning would require denial of the deduction. However, the Tax Court has indicated that this standard is not employed. In *Bituminous Casualty Corp. v. Commissioner,*[136] that court permitted the insurer to deduct retrospective rate credits in unearned premiums even though the policy had not expired during the tax year.[137]

The different treatment of insurer and insured potentially works to defer income tax revenue if losses are substantially less than anticipated. The insurer does not recognize the accrued premium credits as income because it is permitted to include such credits as part of its deduction for unearned income. The insured would have taken a full premium deduction for the original premium. In fact, the

131. I.R.C. § 832(b)(4)(B).

132. Treas. Reg. § 1.832-4(a)(3) (1963). I.R.C. § 832 is generally applicable to insurance companies other than life or mutual companies. Its inclusive scope means that stock insurance companies have the benefit of this section. Note, however, that a mutual company writing a retrospectively rated policy could obtain the equivalent treatment under I.R.C. § 822(c)(1)-(2).

133. Rev. Rul. 67-225, 1967-2 C.B. 238, 242, *overruled on other grounds,* Bituminous Cas. Corp. v. Commissioner, 57 T.C. 58 (1971).

134. *See* pt. II(A) to (C) *supra.*

135. In fact, insurance companies are taxed under a special subchapter of the Internal Revenue Code of 1954. *See* discussion note 201 *infra.*

136. 57 T.C. 58 (1971). The strongly worded opinion gave the insurance industry substantial ammunition in its battle to avoid the application of certain standard tests in calculating underwriting income. For a discussion of this landmark decision, see Lenrow, *Does the Annual Statement Determine Taxable Income? What Does the Bituminous Casualty Case Mean?*, Best's Rev.—Prop./Liability Ins. Ed., Jan. 1972, at 53.

137. The IRS has acquiesced in the result reached by *Bituminous* without explicitly stating that the usual "all events" test was inapplicable to insurance companies. *See* Rev. Rul. 73-302, 1973-2 C.B. 220, 221. Nevertheless, that conclusion is consistent with the result. The tax court decision expressly stated that the "all events" test had no application to insurers. 57 T.C. 58, 60 (1971). For a general discussion of the ramifications of the IRS acquiescence, see Lenrow, *A Prospective View of the Tax Treatment of Retrospective Rate Credits or The Internal Revenue Commissioner Acquiesces to the Bituminous Decision,* Best's Rev.—Prop./Liability Ins. Ed., Sept. 1973, at 41.

proper treatment of the credit due should be as a prepaid expense and therefore it would not be deductible by the insured.

The *Bituminous* court treated retrospectively rated policies as legitimate contracts of insurance. An alternative treatment, to the effect that premiums paid in excess of the minimum premium are only a deposit, would likely destroy the deductibility of such premiums by the payer. Indeed, Revenue Ruling 67-225 had earlier found such a contract to be more than "mere bookkeeping for a fee"[138] because the premium was "subject to minimum and maximum limits thus guaranteeing . . . that every premium paid by a policyholder takes into account the risk charges and loading elements."[139]

While the above discussion indicates that retrospective premiums are fully deductible to the insured, there would seem to be a line of demarcation between such a contract's form and its substance.[140] If that point is exceeded, then a policy which is in form retrospectively rated insurance would be, in fact, "bookkeeping for a fee" and hence subject to the usual restrictions on self-insured programs.[141] Retrospective plans, for example, which set maximum premiums at levels far in excess of reasonably anticipated losses could fail if inquiry were made into the effective degree of risk transfer.

A retrospectively rated plan can be quite similar in financial operation to a mutual insurance company policy with a dividend feature. Many mutuals set rates that will almost certainly result in a fractional premium return (5-10%) to the insured in a subsequent year.[142] Despite the high probability that initial premiums are excessive to the extent of such anticipated dividends, full premium deductibility in the year of payment has generally been permitted.[143] Such treatment, however, is of little precedential value for holding retrospective premiums fully deductible, since retrospectively rated policies and mutual policies are readily distinguishable. A mutual insurance company's performance is dependent on the collective loss experience of all participating policyholders. The premium is available to reimburse the losses of any other insured. A retrospective premium, on the other hand, is exclusively dependent on the loss experience of the individual insured. Thus, the collective performance dependence of the

138. Rev. Rul. 67-225, 1967-2 C.B. 238, 239, *overruled on other grounds,* Bituminous Cas. Corp. v. Commissioner, 57 T.C. 58 (1971).

139. *Id.* A federal district court reviewing an arrangement which was in essence a retrospective insurance contract without a maximum disallowed the premium deduction. The court found that the arrangement, which also provided the insured a portion of investment income, contained no transfer of risk and hence was not an insurance contract. Steere Tank Lines, Inc. v. United States, 76-2 U.S. Tax Cas. ¶9526 (N.D. Tex. 1976).

140. "The taxpayer may not, of course, lift himself by his own bootstraps and secure the allowance of a deduction through the medium of characterizing a particular item on his books and records as an expense." 4A J. Mertens, *supra* note 43, § 25.13, at 85 (1972) (footnote omitted).

141. A discussion of these restrictions is contained in notes 146-57 *infra* and accompanying text.

142. Judicial recognition of this practice was noted in Weber Paper Co. v. United States, 204 F. Supp. 394, 398-99 (W.D. Mo. 1962), *aff'd,* 320 F.2d 199 (8th Cir. 1963).

143. *See, e.g.,* Rev. Rul. 60-275, 1960-2 C.B. 43, 46 (premium deductions permitted to extent they were not withdrawable by the taxpayer).

mutual dividend more clearly reflects the risk distribution concept inherent in insurance relationships.

In summary, insurance premiums paid to unrelated insurers are generally fully deductible in the year of payment even if subsequent loss development could produce reimbursement or require additional premium payments. It is submitted, however, that this favorable treatment is based on a finding of substantial risk transfer, the absence of which could engender successful IRS challenge.

B. *Self-Insurance*

A fundamental principle in any method of insurance ratemaking is that the expected value of the losses insured must be less than the amount of the premium collected.[144] While for individuals there are often large variances between the premium paid and the actual losses, for large organizations this variability is substantially reduced. For some types of risk, these large corporations have sufficient loss exposure to pay for their own losses over a period of time. The insurance premium is merely a means of financing this responsibility. It follows, therefore, that an accounting reserve which is equal in value to the insurance premium could function to stabilize the effects of year to year variation in actual losses—such stabilization being inherent in an insured program.[145] This result would be accomplished by isolating the reserve as a source of funds with which to pay losses. Good experience years would increase the size of the reserve, thus enabling it to later pay for adverse years. The appeal of such a plan to taxpayers probably explains why its treatment was confronted early in the history of the income tax. Tax authorities, however, drew a clear distinction between such accounting procedures and the procurement of insurance.

Brown v. Helvering[146] set forth the rule that contributions to reserves providing for the future payment of contingent liabilities or expenses cannot be accrued and deducted regardless of the reasonableness of such reserves.[147]

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144. When this axiom is not followed, the participating insurance company will ultimately face ruin. H. Seal, Stochastic Theory of a Risk Business 135 (1969).

145. This simplistic discussion of an accounting reserve neglects the fundamental statistical concept that actual losses could vary significantly from a reserve set at an expected value of the losses. Use of such a reserve is actuarially sound only if the self-insured program encompasses a collection of individual risks comparable in number to those required for prudent insurance company operation. In insurance terms, the program must have a credible amount of loss experience. This credibility standard is measured by a mathematical weighting factor which reveals whether an organization's historical loss experience was the result of accidential "good" or "bad" luck or was developed from true differences in loss performance. I. Pfeffer, Insurance and Economic Theory 64-65 (1956). This credibility concept is also a means of determining the likelihood that actual loss experience will deviate from the forecast value. For a collection of several relevant, though mathematical, essays on this subject, see Credibility Theory and Applications (P. Kahn ed. 1975).

146. 291 U.S. 193 (1934).

147. *Id.* at 200-01. The other aspect of the contingency analysis, that dealing with the prorating of income, has received a different treatment. The Treasury Service has been far more

Brown involved an attempt by an insurance agent to establish a reserve for refunding commissions should the associated policy be subsequently cancelled. The agent had developed a formula, based on experience, which permitted him to estimate the fraction of commissions which would have had to be returned.[148] In disallowing the deduction, the Court explained that an accrual (and, therefore, a deduction) would only be permitted when "all events" had occurred that were necessary to define a liability.[149]

Thus, reserves set aside to compensate for possible future losses are not sheltered from income taxes. This broad prohibition against the deductibility of self-insurance reserves was specifically discussed in a series of decisions in the 1920's.[150]

The administrative controls and the method for determining the size of such accounting reserves have often been asserted as factors supporting the taxpayer's contention of deductibility. *Spring Canyon Coal Co. v. Commissioner*[151] gave us an early discussion involving workmen's compensation laws. In 1917, Utah adopted a workmen's compensation law which permitted an employer to use self-insurance to supply the required protection to employees covered by the act. Spring Canyon chose this approach and established an

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apt to find a sufficient basis for a required recognition of anticipated income than to permit a deduction for contingent expenses. *See, e.g.*, Simplified Tax Records, Inc., 41 T.C. 75 (1963).

148. In the past Brown had experienced a policy cancellation rate averaging approximately 22%. 291 U.S. at 197, 201 n.7.

149. The "all events" test has, in fact, been a recurring justification for barring accrual of liabilities even in cases where prudent business practice demands prefunding provisions or, indeed, where accounting principles may require that such reserves be created. "The prudent business man often sets up reserves to cover contingent liabilities." Lucas v. American Code Co., 280 U.S. 445, 452 (1930). For a discussion of the current accounting conventions regarding contingencies, see Financial Accounting Standards Board. Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (1975).

150. In Pan-American Hide Co., 1 B.T.A. 1249 (1925), the taxpayer attempted the straightforward procedure of creating a reserve for anticipated fidelity losses. The amount placed in the reserve was equal to the monthly premiums that had been quoted from outside insurance companies. *Id.* However, the Board of Tax Appeals refused to permit the taxpayer's deduction for the amounts used to establish the reserve stating that such monies were not paid or incurred expenses for the tax year of transfer. *Id.* at 1250. From the facts of the case, it is apparent that there were no losses in 1918, the year in which the reserving procedure was instituted. *Id.* at 1249.

A similar fact pattern is found in L.A. Thompson Scenic Railway, 2 B.T.A. 664 (1925), where the taxpayer was involved in the operation of amusement park facilities. In a situation often encountered by today's insurance buyers, the taxpayer found that "[o]wing to the fire hazard and the risk involved, no insurance company would accept insurance liability on such property owned by the taxpayer." *Id.* at 665. As an alternative financing procedure, the taxpayer set aside an amount representing the estimated minimum premium which it would have paid if any insurance company would have taken the risk. A deduction was disallowed on the strength of *Pan-American*, despite the recognition that conservative accounting practices might necessitate the reserve. *Id.*

151. 13 B.T.A. 189 (1928), *appeal denied*, 43 F.2d 78 (10th Cir. 1930), *cert. denied*, 284 U.S. 654 (1931).

independent operation having appropriate management and clerical personnel to administer the compensation payments.[152] Because this operation had been prefunded by the taxpayer with an amount equal to the premium which would have been required had it purchased insurance from the state fund,[153] and because the fund's size had been monitored by the Industrial Commission of Utah,[154] the corporation contended that it should have been permitted to accrue for income tax purposes the payments made to the fund.

The IRS disagreed, and successfully argued that mere segregation of fund assets did not create a trust for the ultimate payment of workmen's compensation benefits.[155] From the court's acceptance of this argument, it follows that the decision does not apply to instances involving a bona fide trust.[156]

These few early decisions established an essentially unqualified principle that self-insurance reserves are not deductible for income tax purposes. This is so even if the contributions are the equivalent of arm's-length premiums, insurance is not available, and the reserves established for such funds are created pursuant to the state insurance commissioner's procedures. These constraints have broad implications because of the extensive and growing use of self-insurance for workers' compensation liability and other casualty exposures. Unfortunately, the Board of Tax Appeals, in developing this prohibition, provided little explanation of their position. It did not inquire into whether or not the liability had been accepted for cases not settled at the end of the year or consider the possibility of an arm's-length relationship between the taxpayer and a trust. Such considerations, ignored by the Board of Tax Appeals, should be important in expanding the basis for income tax accrual in a contemporary setting. The broad prohibition against deductibility established by these cases is unresponsive to the complex realities involved in modern corporate risk management. Fortunately, several recent decisions discussed below have created some incipient cracks in this traditional barrier.[157]

Crescent Wharf & Warehouse Co. v. Commissioner[158] did not alter the

152. 13 B.T.A. at 190-91.

153. *Id.* at 191.

154. *Id.* at 194.

155. *Id.* at 197.

156. For a discussion of the role of trusts in the prefunding of liabilities, see pt. III(C) *infra*.

157. Legislative relief is also beginning to be seriously considered for certain specific areas. Allowance for tax deductible self-insurance reserves for product liability cases has been proposed by Senator J. Culver (D.-Iowa). *See* S. 1611, 95th Cong., 1st Sess., 123 Cong. Rec. S8763 (1977). A similar, though more flexible, bill has been introduced in the House of Representatives by Representative C. Whalen (R.-Ohio). *See* H.R. 7711, 95th Cong., 1st Sess., 123 Cong. Rec. H5685 (1977), *as corrected*, 123 Cong. Rec. H7158 (1977). This latter bill would use a trust as the vehicle for the funding with stiff penalties if withdrawals are made for any other purpose. *See* Geisel, *Second Bill Proposes Tax Breaks for Self-Insurers*, Bus. Ins., June 27, 1977, at 6, col. 1.

One authority in the risk management field argues that such plans should be considerably broadened to provide complete tax treatment equivalence between loss retention and insurance purchase. Goshay, *Economic Impact of Self-Insurance Reserve Trusteed Funds: Product and General Liability Exposures*, 44 J. Risk & Ins. 521 (1977).

158. 518 F.2d 772 (9th Cir. 1975).

accrual principles discussed above, but it did make the determination of liability on a basis which has practical benefit to many self-insurers. The taxpayer had self-insured its liabilities for state and federal workmen's compensation claims and had sought to accrue the unpaid liabilities estimated for uncontested claims. In the Tax Court's view, injury to an employee in an uncontested case was not sufficient to establish the corporation's liability.[159] This restrictive position was rejected by the Ninth Circuit which stated that "[l]iability is not dependent upon fault or the absence thereof, and denial of liability by [Crescent] is extremely rare."[160]

The Ninth Circuit separated the concepts of determination of liability and the ability to estimate the ultimate payment which were involved with Crescent's right to accrue the liability. The court's innovation lies in finding that liability was determined on the physical facts of the accident because of the "no-fault" nature of the workers' compensation law. In effect, the court assumed that the injured worker would file a claim under the workers' compensation law.[161]

The court discussed *American Automobile Association,*[162] *Consolidated Edison,*[163] and *Milwaukee & Suburban Transport*[164] and distinguished each on the basis that the amounts involved were either contested or completely speculative.[165] The Ninth Circuit was unable to determine whether Crescent's deduction was proper because the Tax Court, in concluding that liability was not fixed, had not pursued the issue of estimation accuracy. The case was therefore remanded to the Tax Court to determine whether the amount of liability could "be determined with reasonable accuracy."[166]

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159. *Id.* at 774.

160. *Id.* at 773. Thus the court adopted the taxpayer's position that while the extent of damages was often unknown at the time a worker was injured, the determination of such amounts was *not* a condition precedent to the taxpayer's liability. "It is respectfully submitted that the events which the lower court regarded as conditions precedent to the creation of the employer's liability are, in fact, events occurring subsequent to the event establishing liability. The injury establishes the fact of the employer's liability. The medical services to the injured employee and his absence from work merely quantify that liability in dollars and cents." Brief for Appellant, at 20, Crescent Wharf & Whse. Co. v. Commissioner, 518 F.2d 772 (9th Cir. 1975).

There was one refinement to this injury-liability link. A deduction was judged improper for those few cases which had occurred within seven working days from the end of the tax year because indemnity payments for workers' compensation were not due under California law unless an employee was absent from work at least seven working days. It certainly can be argued that such a waiting period constitutes a condition precedent to liability rather than merely a factor influencing damages as contended by the appellant. *Id.*

161. *See* Cal. Lab. Code § 3600 (West 1971). The language of the New York statute is characteristic of that adopted by many other states: "Every employer subject to this chapter shall . . . pay or provide compensation for [employee] disability or death from injury arising out of and in the course of the employment *without regard to fault* as a cause of the injury . . . ." N.Y. Work. Comp. Law § 10 (McKinney 1965) (emphasis added).

162. 367 U.S. 687 (1961).

163. 366 U.S. 380 (1961).

164. 367 U.S. 906 (1961).

165. 518 F.2d at 775.

166. *Id.* A private settlement of the case was reached on the basis of stipulations. No written

In summary, under an accrual based system of accounting, it is quite clear that the "all events" test eliminates the opportunity to establish reserves for those loss incidents which have not occurred in the tax year. Even a liability which has been incurred during the tax year in question will not result in a tax deduction if the underlying claim is unpaid and contested. Thus the contingency must be funded with pretax dollars. Tax accounting requirements and, more recently, standard accounting procedures[167] prohibit the taxpayer from utilizing self-insurance reserves in these instances as a substitute for the procurement of insurance coverage. Where, however, corporate liability arises under no-fault theories, as in *Crescent,* or is otherwise uncontested, deductibility should rest on the ability of the taxpayer to estimate the ultimate costs with reasonable accuracy. Furthermore, if the taxpayer can demonstrate past ability to estimate ultimate costs to within twenty percent on an aggregate basis, then neither the larger variances displayed in the case of individual claims nor the mere possibility of conditions subsequent affecting the taxpayer's liability should bar current deductibility of such reserves.[168]

C. *The Trust as a Vehicle for Reserve Accrual*

The trust is a potential vehicle to obtain accelerated deductions for prefunding incurred-but-unpaid-claims. In contrast to self-insured programs, where deductions are often limited to the amounts actually paid to claimants,[169] a trust arrangement would permit a current deduction for the amounts transferred to create the trust.

A trust agreement transfers the legal title of the trust corpus to a trustee and ordinarily limits his discretion in the use and disposition of this property.[170] In contrast, an accounting or book reserve represents monies available for general corporate uses to purchase additional inventory, finance expansion, and so forth. The insular character of trusts has provided taxpayers with an argument for deducting the amounts used to create trusts, in those cases where the trust would ultimately be used to pay corporate business expenses.

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opinion, therefore, is or will be available. Telephone conversation with Arthur B. Willis, Attorney for Crescent Wharf and Whse. Co., (Feb. 17, 1977). While *Crescent* does not abandon the "all events" test, the physical facts of an event may determine liability in various strict liability or no-fault situations, thus placing a right to a deduction on a demonstration of acceptable estimation accuracy. Although *Crescent* concerned workmen's compensation, its logic indicates that self-insurance reserves may be deductible in other no-fault liability areas. *See* Lenrow & Halpern, *The Impact of the Crescent Wharf Case on the Deductibility of Self-Insurance Reserves,* Best's Rev.—Prop./Casualty Ins. Ed., May 1976, at 74.

167. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (1975). The FASB requirements for an accounting accrual for a loss contingency are similar to, though less stringent than, the "all events" test required for a tax accrual. The two essential conditions are (1) "it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements" and (2) "[t]he amount of loss can be reasonably estimated." *Id.* at 4 (emphasis added).

168. *See* pt. II(C) *supra.*

169. *See* notes 150-57 *supra* and accompanying text.

170. *See* Restatement (Second) of Trusts §§ 2, 74 (1959).

The early cases, however, analyzed the problem without regarding the trust entity. For example, *Greenville Coal Co.*[171] involved a trust established for the payment of liability for employee injuries and maintained by periodic payments to the trustee. The approach was unsuccessful since an income tax deduction was allowed only for the amounts actually paid to claimants during that tax year and not for the larger amount transferred to the trust. The Board disregarded the trust entity and barred the larger deduction as a reserve.[172] The opinion provided no rationale for the conclusion and little factual background as to the taxpayer's method of determining the size of the contested reserve.

More recently, statutory provisions[173] have established a useful role for the trust in risk management programs. These statutes, however, operate only within fairly limited boundaries, especially in pre-funding contingent liabilities. The point is illustrated in *Poirier & McLane Corp. v. Commissioner,*[174] where the taxpayer, a construction contractor, was sued for damages to properties adjacent to two construction sites. In 1964 McLane established a trust agreement and deposited a total reserve equal in size to the payments expected to arise out of the litigation.[175] The trust agreement provided that the balance of the fund would be returned to the corporation after the disposition of the specific claims.

After establishing this trust fund, the corporation relied on section 461(f) of the Internal Revenue Code[176] to deduct the amount of transferred funds in the year of their transfer.[177] The IRS opposed the deduction arguing that the creation of the trust did not constitute a sufficient removal of control by McLane and, therefore, did not meet the requirements of section 461(f) as interpreted in the applicable Treasury Regulations which provide:

> A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a *written agreement* (*among the escrowee or trustee, the taxpayer, and the person who is asserting the liability*) that the money or other property be delivered in accordance with the settlement of the contest . . . .[178]

The Tax Court found that "[i]n no way could petitioner have reaquired or otherwise controlled the entrusted funds until the purpose of the trust [to pay the liabilities involved in the identified lawsuits] had been achieved."[179] On this finding, the court had concluded that the transaction satisfied the

171. 3 B.T.A. 1323 (1926).

172. *Id.* at 1327.

173. *See generally* I.R.C. §§ 461(f), 501(c)(9). Payments used to fund employees' beneficiary associations are tax deductible if they qualify under §§ 401 and 404 of the Code.

174. 547 F.2d 161 (2d Cir. 1976), *cert. denied,* 97 S. Ct. 2925 (1977).

175. *Id.* at 163.

176. This section is quoted in full in note 61 *supra.*

177. 547 F.2d at 163.

178. Treas. Reg. § 1.461-2(c)(1) (1964) (emphasis added).

179. 63 T.C. 570, 578 (1975).

conditions for a valid transfer of control and permitted the deduction.[180]

The Second Circuit reversed.[181] While the court recognized that section 461(f) was intended to remove an unreasonable barrier to deductibility when amounts were actually paid, it nevertheless determined that the discretion permitted by the Tax Court as to the timing and amount of such transfers would go beyond the legislative intent[182] and would provide opportunity for abuse.[183] The court did, however, suggest that potential abuse could be controlled by requiring that, the claimant-beneficiaries be made a party to trust agreement.[184]

The Tax Court had specifically rejected this requirement[185] largely on the basis that the resultant disclosure of the evaluation of the claim would destroy one's negotiating position in a contested matter.[186] However, the Second Circuit stated that placing the taxpayer in an " 'unnatural litigating position' by requiring disclosure of [his] evaluation of the claim was irrelevant."[187] In that court's view, Code section 461(f) was designed to aid the accrual taxpayer in certain limited circumstances[188] which were not satisfied in the instant case.[189]

The potential for abuse which might result from permitting a deduction in the year of the taxpayer's choice "by the simple expedient of transferring assets to a trust"[190] was an important consideration in the Second Circuit's

180. *Id.* at 581. The nonrevocability feature made a stronger case for the taxpayer. *See* Consumers Oil Corp. v. United States, 188 F. Supp. 796 (D.N.J. 1960) (oil company's annual payments to a revocable trust to provide against uninsurable flood damage not allowed as a business expense).

181. 547 F.2d 161 (2d Cir. 1976), *cert. denied,* 97 S. Ct. 2925 (1977).

182. *Id.* at 166 n.10. Relying on S. Rep. No. 830, 88th Cong., 2d Sess. (1964), *reprinted in* 1964-1 (Part 2) C.B. 505, 604, the Tax Court drew the broad conclusion that the objective of Congress was "to allow deductions for sums transferred to pay such asserted liabilities in the year in which the related income was earned rather than in some later year when the contest over such liabilities was settled . . . ." 63 T.C. at 575.

183. 547 F.2d at 167.

184. *Id.*

185. 63 T.C. at 579-81. Surprisingly, in light of the regulation's wording, the majority of the Tax Court found that such signatures were unnecessary. *Id.* In fact, a five-judge concurring opinion in the Tax Court stated that if the regulation did require the signature of the beneficiaries (*i.e.,* those asserting liability), then the regulation should be declared invalid. *Id.* at 581 (Forrester, J., concurring). There is, of course, no general requirement that the beneficiaries (in this context, claimants) have knowledge of the trust. G. Bogert & G. Bogert, The Law of Trusts and Trustees § 169 (2d ed. 1965); 1 Restatement (Second) of Trusts § 36 (1959); 1 A. Scott, The Law of Trusts § 36 (3d ed. 1967).

186. 63 T.C. at 581-82 (Forrester, J., concurring).

187. 547 F.2d at 167.

188. Such circumstances include the payment of a contested tax or other instances where the control of money or other property is, in fact, lost and there is little discretion provided to the taxpayer as to the timing of the transfer payments. Some factual examples are presented in Treas. Reg. § 1.461-2(a)(4) (1964).

189. 547 F.2d at 167.

190. *Id.* (footnote omitted).

decision. Indeed, the facts of the case demonstrate the potential for abuse. McLane ultimately won the underlying lawsuits and thus gained the benefit of a tax-sheltered reserve for the years of litigation.[191] The Tax Court would have opened the door to abuse by its evaluation of the accuracy of the taxpayer's estimation of his potential liability on the basis of his good faith in initially setting the size of the trust.[192] This approach is in sharp contrast to the objective, retrospective test for estimation accuracy employed in the "all events" test.[193]

In sum, a trust provides a tax deductible method for the prefunding of employee benefits if it is operated within the scope of Code section 501(c)(9).[194] The broader allowance of section 461(f), however, does not generally provide a practical avenue for the deductibility of reserves for self-insured property and liability exposures. Although, unlike the self-insurer under the *Crescent Wharf* standard,[195] the taxpayer may actively contest liability, the requirement of obtaining the signatures of the claimant beneficiaries prematurely exposes the corporation's negotiating position.

For practical risk management purposes, a trust under Code section 461(f) can only be used in limited circumstances,[196] such as a situation where the aggregate damages have been stipulated but the allocation among the claimants is in issue or where the taxpayer is not opposed to disclosure and the claimants are willing to accept the trust property as the basis of their claims against the taxpayer.[197] A more useful approach would be to abandon the

191. Of course, any amount so refunded generally must be included in gross income in the year the contest was settled. Treas. Reg. § 1.461-2(a)(3), (4) (1964).

192. *See* 63 T.C. at 581 n.12.

193. *See* pt. II(C) *supra*.

194. The trust itself is exempt from taxation if it is "providing for the payment of life, sick, accident, or other benefits to the members" of a voluntary employees' beneficiary association. I.R.C. § 501(c)(9). The general rule that an employer may take a tax deduction for contributions paid to such plans is discussed in Treas. Reg. § 1.162-10(b) (1958).

195. *See* text accompanying notes 158-66 *supra*.

196. On the other hand, New York's legislation enabling municipal self-insurance reserves exemplifies wide flexibility by not limiting the size of the fund but only restricting its ultimate use. *See*, N.Y. Gen. Mun. Law § 6-j (McKinney 1977). Legislation allowing corporations to establish trusts for prefunding liabilities would likely have to impose limits on the allowable trust size although several options exist for exercising such control. Among these are: (1) limiting the size to what would have been the reasonable cost for insurance, or (2) limiting the maximum size to a specific fraction of the taxpayer's gross receipts. Both of these concepts raise serious practical difficulties. In the former, insurance in a traditional form may be unavailable at any price and, in the latter, corporations display tremendous variability in the relative cost of random hazard risks to their operations. A more workable solution is to require the taxpayer to forecast the size of the required trust on an annual basis and to provide penalties if the actual payments vary by more than twenty percent from the forecast.

197. A recent legislative proposal for providing relief to self-insurers against product liability would create a tax deduction for monies placed into a trust for the ultimate settlement of such claims. *See* discussion note 157 *supra*.

signature requirement and to impose an objective test[198] for estimation accuracy.

D. *The Captive Insurance Company*

1. The Rationale for Creation

The principal driving forces underlying the creation of a captive insurance company are potential cost savings and increased flexibility in the parent corporation's risk management program. The financial benefit has three potential sources: lower operating expense, income tax deferrral, and economies in purchasing reinsurance protection as compared to alternative insured or noninsured plans.[199] The captive, given an adequate premium income, can reduce insurance expenses because it is a vehicle for funding the corporation's risk exposure without the loss of underwriting profits or investment income. While a legitimate ratemaking procedure for a captive must provide for profit, overhead, and acquisition expense, these amounts will often be less than the equivalent provisions required by an unrelated insurer. Furthermore, they are retained within the framework of the corporate family.

Income tax ramifications, the second source of potential financial benefit, depend on defining the relationship between the captive and the parent. If, contrary to the IRS position,[200] the captive is granted the status of a bona fide insurance company, then net cost savings can arise which are greater than those achieved by self-insured or retrospectively rated insurance programs. This occurs, in part, because of the specialized federal income taxation rules applicable to insurance companies.[201]

One might intuitively suppose that the tax treatment of insured and insurer would tend to offset one another because a deduction to the insured would be income to the insurer. Such a cancellation does not occur, however, because of the advantageous income tax treatment granted insurance companies. These tax advantages stem from two major sources: (1) the exclusion of "unearned premiums" from the insurer's gross income,[202] and (2) the right to deduct incurred losses and expenses not limited to those actually paid from current income.[203] Since a premium paid to a captive would be a business

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198. A recommended standard for such a test is that the taxpayer demonstrate an ability to estimate within twenty percent of the ultimate value. *See* pt. II(C) *supra*.

199. *See generally* Warren, McVeigh, Griffin & Huntington, *Captive Insurance Companies*, Rep. No. A-16, in Practical Risk Management (1976) [hereinafter cited as *Captive Insurance Companies*]; Kloman, *The Captive Life Insurance Company*, Financial Executive, Mar. 1972, at 44; Pine, *The Case for 'Captive' Insurers*, 1972 Harv. Bus. Rev. 142; Saggese, *supra* note 37, at 527-28.

200. *See, e.g.*, Rev. Rul. 77-316, 1977-35 I.R.B. 7. The position of the IRS is discussed at notes 211-16 *infra* and accompanying text.

201. Insurance companies are taxed in accordance with the provision of chapter 1, subchapter L of the Internal Revenue Code of 1954. The Code essentially distinguishes life, mutual, and stock insurance companies. I.R.C. §§ 801-844.

202. I.R.C. § 832(b)(1), (b)(4).

203. I.R.C. § 832(b)(5)(B), (c)(4).

expense,[204] the net result of the transaction is that the insured parent receives the accelerated deduction of the unpaid liabilities which could not generally be achieved under self-insurance plans.[205]

A third financial advantage arising from the use of the captive is the opportunity provided to deal directly with reinsurance markets. Even regular insurance companies, as well as captives, rarely retain the full amount of risk on the policies they write. Instead, they use the mechanism of reinsurance to pass off layers of risk, thus providing stability in their underwriting results.[206] Some authorities have stated that access to such reinsurance markets means, in effect, the ability to buy insurance at wholesale rates. While the extent of these savings may be debated,[207] it seems clear that dealing with reinsurance markets allows the insurance buyer flexibility in transferring risk.

In addition to financial benefits, there can be management incentives for the creation of a captive insurance company. Among these is the centralization of all the risk management activities of a major corporation. The captive can become a vehicle for monitoring this financial responsibility, administering the determination of premiums for the various corporate divisions or subsidiaries, and controlling the corporate-wide loss control and safety programs. Because a captive is a profit center, the corporation is afforded an objective means of measuring its performance by comparing its operating characteristics with those of other insurance companies.[208]

Whether the positive factors discussed above[209] are sufficient to compensate for the extra administrative and managerial costs of a captive requires an in-depth financial analysis. The analysis should consider the anticipated rate of actual pay out of incurred liabilities and expenses (and thus, the investment income potential associated with incurred-but-not-paid losses); the additional management and accounting fees required for the operation of a captive; the assessment of state premium taxes and the possibility of federal excise taxes; and, the opportunity cost associated with the capital and the surplus funds of the captive required to provide sufficient financial resources in case of adverse loss experience.[210]

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204. *See* Treas. Reg. § 1.162-1(a) (1975).

205. The *Crescent Wharf* line of reasoning, in the self-insurance context, would provide for such an accelerated deduction only if far more stringent conditions were met, *i.e.*, that the liability not be contested and the amount be capable of estimation. *See* notes 158-66 *supra* and accompanying text.

206. General Insurance, *supra* note 2, at 165-67.

207. Both sides of this contention are discussed in Goshay, *supra* note 38, at 112-13. A more recent review has indicated that direct access to reinsurance markets is the most important reason for forming a captive. *Captive Insurance Companies, supra* note 199, at 1.

208. Goshay, *supra* note 38, at 116-18. The captive concept is, however, not a panacea for risk management problems. For a balanced discussion of the advantages and disadvantages of the captive concept, see Palmer, *Captive Insurance Companies—Caveat Emptor!,* Best's Rev.—Prop./Liability Ins. Ed., May 1974, at 28.

209. *See* notes 199-208 *supra* and accompanying text.

210. *See generally* Stevenson, *Captive Insurance—Risk Replaces Premiums,* N.Y. Times, May 29, 1977, § 3, at 1, col. 1.

2. The IRS Challenge

The IRS, in reviewing the relationship between a parent corporation and its captive insurance company, concentrates on two major areas: first, the captive's status as a bona fide insurance company and, second, the nature of the contractual relationship between the captive and the parent. While there have been no court decisions refining the issues, unequivocal IRS policy opposes the use of a captive and it will routinely challenge the deductibility of premiums paid by the parent to the captive.[211] This policy has been indicated in some administrative procedures,[212] in preparatory documents filed in cases now in litigation,[213] and in a recent revenue ruling.[214]

The IRS employs three principal lines of attack against the use of a captive. The first argument is that the contract between captive and parent is not one of insurance because the common economic position of the related parties means that no risk shifting or risk distribution has occurred. Thus, the amount of premium paid to a captive is not an expense "paid or incurred" in the taxable year and may only be deducted to the extent otherwise permitted self-insurers under the constraints of code sections 162 and 165.[215] Second,

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211. The lack of a precise definition for "captive" insurance companies can lead to confusion. The IRS position clearly applies to foreign domiciled captives exclusively insuring or reinsuring the risks of its parent corporation. It has been generally believed that if premium income from insuring the risks of unrelated parties is above some fraction of the captive's total income, then the taint of parent-captive dealing would be removed. A minimum fraction of unrelated premium income is not defined at this point. *See* discussion note 37 *supra*.

The economic family theory which the IRS espoused in Revenue Ruling 77-316 may exclude the above means of removing the parent-captive taint. This theory would deny the insured-insurer status between parent and wholly owned insurance subsidiary whenever the "ultimate economic burden of loss [is on] the same persons who suffer the loss." Rev. Rul. 77-316, 1977-35 I.R.B. 7-8. The IRS view expressed in the above revenue ruling could be interpreted to bar the parent's-premium deduction to the extent the captive retained the risk regardless of the volume of the captive's unrelated premium income. *See* discussion note 214 *infra*.

212. *See* IRS, Captive Offshore Insurance or Reinsurance Companies, Manual Supplement 42G-256, amend. 1, §§ 3.01, .03 (Jan. 10, 1972) [hereinafter cited as Manual Supplement].

213. Notice of Deficiency (L-21) from D. Alexander (Comm'r of IRS) to Ford Motor Co. (Jan. 29, 1975) (reference L-21 Code 430) (*see* Explanation of Adjustments, item (a)); Notice of Deficiency (L-21 AD) from D. Alexander (Comm'r of IRS) to Carnation Co. (March 31, 1976) (reference Ap:LA:NEE:CLH:90-D) (*see* Explanation of Adjustments, item (a)). For a brief discussion of the issues, see LeRoux, *Ford Motor Skirmish with IRS over Captive Is Landmark Case*, Bus. Ins., Dec. 1, 1975, at 1, col. 3, and LeRoux, *Carnation vs. IRS in Key Captive Case*, Bus. Ins., Dec. 27, 1976, at 1, col. 1.

214. Rev. Rul. 77-316, 1977-35 I.R.B. 7. Three different sets of circumstances are described in the revenue ruling: (1) insurance premiums paid directly to a captive, (2) insurance premiums paid to a commercial insurer which reinsured 95% of the risk to the captive, and (3) insurance premiums paid directly to a captive with 90% of the risk reinsured in the commercial reinsurance market. In all three cases, the ruling states that the net premium amount which ultimately resides in the captive insurance company is not deductible by the parent. In short, the independent existence of the captive insurance company is disregarded to the extent that it actually bears the risks of the parent. *Id.* at 7-8.

215. The tax treatment of self-insured plans is discussed in pt. III(B) *supra*.

the IRS contends that deductibility of premiums paid to the captive should be disallowed under section 269 of the Code since the captive was formed for the "principal purpose" of securing a tax advantage to which the corporation was not otherwise entitled. The third argument is that the amount of premium paid to a captive may represent an excessive deduction to the parent because of improper allocation of income and expense between the captive and the parent corporation under section 482. This third attack requires an analysis of the ratemaking procedures of the captive to determine if those rates reflect the legitimate economies resulting from the status of the parties.[216]

It is submitted that a viable defense to the first argument requires that the captive be organized and operated as a bona fide independent company. Since the IRS will examine the substance of the relationships rather than rely on legal formalisms, a reasonable starting point for review is the definition of an insurance company which is provided in the Treasury regulations.[217] If properly organized, the captive should be predominantly involved in conducting an insurance operation. However, the fact that all, or essentially all, of the risks involved are those of the parent corporation, raises a question of whether the parent-captive relationship can be considered one of insured to insurer.[218] In this situation, the IRS might argue that the captive's "primary and predominant business activity"[219] was the investment management of the loss reserves and capital rather than the issuance of insurance contracts.[220]

A meticulous analysis of the relationship between parent and captive is

216. Manual Supplement, *supra* note 212, § 3.01(4). Although the Manual Supplement is specifically directed to "the treatment of premiums paid to . . . captive *offshore* casualty insurance . . . companies . . . ," *id.* § 1 (emphasis added), the general consensus in the insurance industry is that this policy is also applicable to domestic captive insurance companies since the IRS argument does not depend on the domicile of the captive, *see Captive Insurance Companies, supra* note 199, at 4.

217. "*Insurance company.* (1) The term 'insurance company' means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code." Treas. Reg. § 1.801-3(a)(1) (1972).

218. The IRS, while stating that its analysis "recognizes [the captive] as [an] independent corporate entit[y]," concludes that no insurance can arise within one "economic family." Rev. Rul. 77-316, 1977-35 I.R.B. 8. The definition of economic family will be developed in future regulations or statutes and will probably be litigated.

219. Treas. Reg. § 1.801-3(a)(1) (1972).

220. See Alinco Life Ins. Co. v. United States, 373 F.2d 336 (Ct. Cl. 1967), where the validity of a limited purpose reinsurer of credit insurance was upheld against challenge. Thus, the IRS does not have an overwhelmingly strong argument based solely on the status of the parties. The case is discussed in more detail at notes 248-54 *infra* and accompanying text. Arguments on behalf of the captive's status as a bona fide insurance company vis-à-vis its parent, have assumed that some risk of loss does reside in the captive. An insurance company that disposes of all its insurance business through reinsurance contracts ceases to be an insurance company under the Code and would be taxed as an ordinary corporation. *See* Rev. Rul. 56-106, 1956-1 C.B. 313.

clearly necessary. This relationship is usually documented in the insurance contract, which can provide for risk shifting and risk distribution.[221] The risk shifting concept requires that the premium payment has relieved the insured party from some defined risk of contingent loss, while risk distribution involves placing the insurer in the position of underwriting a common risk from a number of insureds. The exact definition of these terms, however, has not been developed. Furthermore, there is no quantitative measure of the necessary extent to which these features must be present in a contract to show compliance with the standard.

The first element that would demonstrate effective risk shifting is that the captive have sufficient financial capacity to fulfill its risk retention responsibilities. Risk shifting is classically achieved by the issuance of guaranteed cost insurance programs. That is, a program in which the risk of loss—within predefined limits—is transferred to a third-party for a fixed price. However, contemporary insurance programs for large corporations increasingly employ retrospectively rated policies which reduce the potential variance between the ultimate premium and the realized losses.[222] Yet these retrospectively rated policies are accepted as insurance contracts.[223] The use of these insurance contracts by a captive would reduce the degree of risk transfer because, subject to the retrospective premium limits, the actual losses would determine the ultimate premium. This plan, if carried to the extreme of providing coverage equal to the premium, would severely weaken the captive's defense against a charge of a lack of risk shifting.[224]

The captive's ability to perform on its obligations can be demonstrated by organizing and operating the captive with a level of capitalization and surplus consistent with the risks insured. The capital should also be measured against the various rules of thumb employed in the insurance industry and often reflected in state regulatory requirements.[225]

Furthermore, the solvency of the captive should be protected by procuring reinsurance so that the risk retained by the captive is consistent with its premium and capital position.[226] The equivalent result may be achieved by

221. *See* Helvering v. Le Gierse, 312 U.S. 531, 539 (1941).

222. For a general discussion of retrospectively rated insurance programs, see notes 118-43 *supra* and accompanying text.

223. *See, e.g.*, Rev. Rul. 67-225, 1967-2 C.B. 238, 239, *overruled on other grounds*, Bituminous Cas. Corp. v. Commissioner, 57 T.C. 58 (1971).

224. *See* discussion of Helvering v. Le Gierse, 312 U.S. 531 (1941), at notes 240-42 *infra* and accompanying text.

225. *See, e.g.*, N.Y. Ins. Law § 311 (McKinney 1966 & Supp. 1977). This section defines the minimum capitalization requirements as a function of the type of insurance underwritten. For example, $300,000 is the amount established for personal injury liability insurance or workmen's compensation and employers' liability insurance. *Id.* § 311(1)(c). Another limitation on minimum capitalization is the general requirement that "no insurer . . . shall expose itself to any loss on any one risk in an amount exceeding ten per cent of its surplus to policyholders." N.Y. Ins. Law § 47 (McKinney 1966). Thus, writing a policy covering up to $100,000 per workmen's compensation loss occurrence would impose a surplus requirement of $1,000,000.

226. The fact that a reinsurance company is willing to offer coverage to the captive is itself an

the two-stage process whereby the parent insures directly with an independent insurer and the captive accepts a predefined amount of reinsurance from that primary insurance company. Such a plan not only limits the liability of the captive but also provides a means for the parent to avoid a direct relationship with the captive.[227]

The second element necessary to demonstrate effective risk shifting to the captive would be that the premium charged is one which would characterize an arm's-length relationship. The parent can hardly claim that a valid insurance contract exists when the risks transferred are expected to produce losses in excess of the premium—excesses which will be the ultimate responsibility of the parent corporation.[228]

United States v. Weber Paper Co.[229] defined one boundary in this relatively undefined area of the law. The case involved the operation of a reciprocal insurance company providing flood insurance to its participants. The coverage arrangements were quite simple. Each subscriber obtained insurance protection equal to his premium plus the accumulated level of premium deposits based on the experience of prior years.[230] The company had been organized because the area had suffered several serious floods and no insurance protection had been available, from private or government sources.[231] The corporate insureds took a tax deduction for the premium as a business expense which the IRS challenged, claiming that the "premium" was not deductible as it was merely a deposit with no real risk shifting.[232] Although the subscribers were permitted to take the deduction, the circuit court's opinion was sympathetic to the logic of the Government's position, that the

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indication of the captive's economic independence. Indeed, captive insurance companies may themselves become providers of reinsurance capacity as such companies seek to obtain business from unrelated parties. The concept of captives as a "third market" has been discussed in Kloman, *Captive Insurance Companies—1977,* 4 Risk Management Rep. No. 1, at 6 (1977).

227. The absence of such direct relationship has not removed IRS objection. *See* discussion note 214 *supra.* A reinsurance arrangement was used in the Carnation Company program where Carnation's property insurance was written directly with the American Home Assurance Co., which in turn reinsured 90% of the exposure with Three Flowers Assurance Ltd., a captive of Carnation. Carnation Co. v. Commissioner, *petition docketed,* No. 5793-76 at 6-7 (T.C. June 23, 1976). A major incentive for the use of reinsurance captives is that many forms of insurance impose severe regulatory controls on insurance contracts, whereas reinsurance agreements, *i.e.*, a relationship between insurers, are far less restricted. For example, the Colorado statute generally prohibits a captive from accepting insurance except from its parent, whereas reinsurance business is not so restricted. Colo. Rev. Stat. § 10-6-104-(1)(b), (2) (1973 & Cum. Supp. 1976). The point is discussed in Barnes, *The Colorado Captive Insurance Company Law: An Answer to IRS Objections?*, 1977 Ins. L.J. 85.

228. Of course, the insolvency of the insurer constitutes a breach of contract, and the insured would have a basis for a claim for damages as a creditor of the insolvent company. 2 G. Couch, Cyclopedia of Insurance Law § 22:68, at 756 (2d ed. 1959).

229. 320 F.2d 199 (8th Cir. 1963), *aff'g* 204 F. Supp. 394 (W.D. Mo. 1962).

230. *Id.* at 203.

231. *Id.* at 201.

232. 204 F. Supp. 394, 399-400 (W.D. Mo. 1962).

premiums were nothing more than deposits retrievable at the taxpayer's whim.[233]

The principal questionable practices were: (1) the subscribers had extremely flexible cancellation rights;[234] (2) on cancellation, subscribers could "recapture 99% of [their] annual premium deposit . . . on 60 days' notice . . .";[235] and (3) the nature of the flood risk was such that all subscribers would be likely to sustain a concurrent loss, particularly because the subscribers were classified as those "whose insured properties or businesses are located in the same flood district. . . ."[236] Balanced against these considerations was the pressing need for some form of flood protection, which apparently could not be satisfied from private insurance sources. Furthermore, the structure of the plan involved a collection of independent subscribers and the organization was supervised by the Superintendent of Insurance in Missouri.[237]

Contractual arrangements between the corporate insured and the captive could eliminate some of the obvious weaknesses raised in *Weber*. Nevertheless, the parent-captive relationship is on inherently weaker ground than such pooling relationships because of the absence of risk distribution among a group of insureds.[238] If the IRS requires that insurance contracts contain some degree of risk distribution, that is, a sharing of the risk of loss among a number of independent insureds, then a captive which writes the risks of the parent exclusively fails to qualify by definition.[239]

The requirement for risk distribution as a necessary attribute of an insurance contract is based on the Supreme Court's language in *Helvering v. Le Gierse*.[240] However, the facts of that case reveal that the issue was only one of lack of risk shifting, not a lack of risk distribution. In *Le Gierse*, a decedent, at the age of 80, had executed a $25,000 insurance contract for a premium of $22,946. The insurer had also required the simultaneous execution of a separate annuity contract entitling decedent to receive $589.80 annually for as long as she lived. The consideration for the annuity was $4,179.[241] Although the contracts were legally distinct, the Supreme Court considered both and recognized that their combined effect nullified any risk shifting to the insurer.[242] The Court's decision was based on the effective operation of the contractual terms. While a contractual relationship between insurer and in-

233. 320 F.2d at 204.

234. *Id.* (permitted on five days notice).

235. *Id.*

236. *Id.* at 203.

237. *Id.* at 202.

238. It should be noted that the IRS has not acquiesced in the *Weber* position. Rev. Rul. 64-72, 1964-1 C.B. 85.

239. This is essentially the conclusion urged by the IRS in Rev. Rul. 77-316, 1977-35 I.R.B. 7. *See* discussion note 214 *supra*.

240. 312 U.S. 531, 539 (1941). Note that in reviewing this case, the Treasury Service used the language "an element of risk-shifting *or* risk-distributing is *one* of the requisites of a true insurance contract." Rev. Rul. 60-275, 1960-2 C.B. 43, at 45 (emphasis added).

241. 312 U.S. at 536.

242. *Id.* at 540-41.

sured which transfers no risk would properly fail to be granted the status of an insurance contract, it is improper to extend *Le Gierse* to void a contract between parent and captive which does transfer the risk of loss and where that captive can demonstrate the requisite financial capability.

There is a further reason why risk distribution is not a *sine qua non* of an insurance contract. Most state statutes define insurance in a way that clearly embraces situations where there are only two parties.[243] Since the states are the principal regulators of insurance companies, these statutes should be a major influence on IRS policy.[244]

The discussion above has addressed the essential requirements associated with risk shifting and discounted the necessity for risk distribution to characterize an insurance contract. If the latter is a requirement, the most effective response is to have the captive broaden its portfolio of risks to generate some fraction of its premium income from the insurance of risks outside those of the parent.[245] This would permit the captive to demonstrate a degree of risk distribution. When the business mix reaches some threshold, there can be no doubt as to the bona fide nature of the captive as an insurance company. While some experts have indicated that "10% is certainly significant and 5% may be enough,"[246] the definition of an acceptable lower boundary is still a matter to be developed by the judicial process.

The second potential contention of the IRS is that the parent insured corporation created the captive subsidiary for the "principal purpose"[247] of acquiring a deduction not otherwise available to the parent. This challenge to the use of an insurance subsidiary was rejected in *Alinco Life Insurance Co. v. United States,*[248] which involved the operation of a credit life reinsurance company writing primarily the credit life risk of clients of the parent finance company. The insurance was directly written by an independent insurer that had the necessary expertise to operate a credit life company. A reinsurance

243. *E.g.,* the New York statute provides: "The term 'insurance contract,' as used in this chapter, shall . . . be deemed to include any agreement or other transaction whereby *one party,* herein called the insurer, is obligated to confer benefit of pecuniary value upon *another party,* herein called the insured or the beneficiary, dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event." N.Y. Ins. Law § 41(1) (McKinney 1966) (emphasis added).

244. Congress has clearly expressed its desire that the insurance industry shall be regulated by the states rather than by the federal government. "Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States." McCarran-Ferguson Act § 1, 15 U.S.C. § 1011 (1970).

245. *See* Barnes, *The Colorado Captive Insurance Company Law: An Answer to IRS Objections?,* 1977 Ins. L.J. 85, 87.

246. *See* LeRoux, *Ford Motor Skirmish with IRS over Captive Is Landmark Case,* Bus. Ins., Dec. 1, 1975, at 2, col. 3.

247. I.R.C. § 269(a).

248. 373 F.2d 336, 341 (Ct. Cl. 1967).

relationship existed between this primary insurer and Alinco under the terms of which Alinco reinsured eighteen percent of all the credit life risks of the primary company.[249]

Fundamental to the court's rejection of the section 269 violation was its conclusion that several valid business motives supported the creation of Alinco. Furthermore, the court cited with approval *United States v. Cumberland Public Service Co.*[250] for the proposition that "even a 'major motive' to reduce taxes will not vitiate an otherwise valid and real business transaction."[251] In *Alinco,* the nature of the credit life insurance business provided ample reason for the creation of Alinco.[252]

The court in *Alinco* also considered the special status that state laws have in the regulation of insurance companies. The court stated that "the Internal Revenue Service may not employ the Federal tax laws in an effort to enforce its own concept of what state law should, or should not, be."[253] In so ruling, the court was especially concerned that the application of the Internal Revenue laws might become an indirect means of regulating insurance companies—a task which has clearly been left to state authority.[254]

The "principal purpose" challenge can thus be refuted by a showing that nontax incentives were fundamental in organizing the captive. Several such reasons for operating a captive have been previously discussed.[255] As long as such purposes are present and the captive participates in an arm's-length relationship with the parent, this attack should fail.

The third principal argument against the use of a captive relies on Internal Revenue Code section 482, which raises the issue of whether the premiums between the related parties clearly reflect their incomes. The primary concern of the IRS is that related parties will allocate their aggregate income and expenses in a manner to reduce improperly the total taxable income.[256]

In using this challenge, the IRS necessarily accepts the independent status of the captive insurance company. Thus, only questions of income allocation between the parent and the captive may be raised rather than a fundamental challenge to the economic reality of the captive. Section 482 should not pose a problem for the properly organized captive because its ratemaking methods

249. That is, Alinco received eighteen percent of the premiums and was responsible for eighteen percent of the losses. *Id.* at 339.

250. 338 U.S. 451 (1950).

251. 373 F.2d at 343.

252. Credit life insurance, at the time of the decision, was marketed as a secondary aspect of a loan transaction so that borrowers were generally insensitive to high premiums. These conditions raised the issue of how the profits could be shared between the credit company and the primary insurer. The reinsurance arrangement provided such a mechanism, and it did not raise various legal problems as did alternatives such as receipt of commissions or retrospective premium adjustments. *Id.* at 338-43.

253. *Id.* at 345.

254. *Id. See also* discussion note 244 *supra.*

255. *See* notes 199-210 *supra* and accompanying text.

256. *See, e.g.,* South Texas Rice Whse. Co. v. Commissioner, 366 F.2d 890, 898 & n.19 (5th Cir. 1966), *cert. denied,* 386 U.S. 1016 (1967).

would have eliminated any fees which, because of the relationship of the parties, may not conform to usual insured-insurer convention. For example, if the captive is in the position of operating with lower costs for business acquisitions, commissions, or other expenses as compared to independent insurers, then the premiums charged should be somewhat below those of the market. Such discounts, however, must not be so excessive as to be inconsistent with the risk transferred.[257]

There are to date no cases which serve to indicate the effectiveness of the IRS triple challenge developed above, or conversely, the viability of the captive insurance concept. The insurance industry has anxiously awaited a definitive court decision for the past several years.[258] While great publicity has been achieved by those cases which have begun the litigation process,[259] the lengthy procedural mechanics of the Tax Court[260] and the clear possibility of a private settlement have so far contributed to the absence of any court guidelines.

The first of these litigations is *Ford Motor Co. v. Commissioner,*[261] which involves the operation of a foreign insurance subsidiary (Transcon) writing insurance for Ford's non-U.S. operations. The operating characteristics of the captive indicated that it was adequately capitalized and staffed with knowledgeable personnel.[262] The business incentives for the operation included reduction of the costs which the foreign subsidiaries would have been required to pay to independent insurers and provision of these subsidiaries with types of coverage not otherwise available.[263] Ford stated that the captive was now providing reinsurance coverage "to wholly unrelated parties at rates estab-

257. Insurance ratemaking procedures are dependent on the type of risk and on the loss and exposure data available. For a nontechnical discussion of this process, see D. MacDonald, Corporate Risk Control 75-90 (1966). As an example of such considerations, if the insurance coverage were negotiated between captive and parent without the mediation of a broker, his commission would be saved. While the premiums should reflect this lower cost, the courts have been reluctant to extend this logic to distribute income to an entity which by law could not have directly received the disputed income. *See, e.g.,* Commissioner v. First Security Bank, 405 U.S. 394, 404-05 (1972) (bank prohibited by law from receiving insurance commissions cannot have such commissions assigned to it on a § 482 allocation).

258. The publication of Rev. Rul. 77-316, *see* note 214 *supra,* has only heightened the insurance industry's need for a definitive resolution.

259. *See* LeRoux, *Ford Motor Skirmish with IRS over Captive Is Landmark Case,* Bus. Ins., Dec. 1, 1975, at 1, col. 3; LeRoux, *Carnation vs. IRS in Key Captive Case,* Bus. Ins., Dec. 27, 1976, at 1, col. 1.

260. After receipt of a notice of deficiency, the taxpayer has ninety days to file a petition with the Tax Court for a review of the deficiency. During the pendency of this automatic appeal no tax collection can be made. I.R.C. § 6213(a). Furthermore, the parties to the tax court action have an automatic right of appeal to the appropriate federal circuit court of appeals. I.R.C. §§ 7482, 7483; *see* J. Chommie, The Law of Federal Income Taxation § 301 (2d ed. 1973).

261. *Petition docketed,* No. 3660-75 (T.C. Apr. 25, 1975).

262. Petition for Appellant at 7, Ford Motor Co. v. Commissioner, *petition docketed,* No. 3660-75 (T.C. April 25, 1975).

263. *Id.* at 6.

lished in the worldwide reinsurance market."[264] However, no quantitative measure of this third-party business was provided. Although the section 482 argument[265] was not directly discussed, Ford supported its case by pointing out that premiums "were based on arm's-length amounts which would have been charged by unrelated insurers for comparable risks."[266] Ford stated that such premiums paid by the various subsidiaries were never challenged as to their reasonableness or disallowed as a deduction by the taxing authorities of other countries.[267]

The IRS contention in *Ford* is that the premiums received by Transcon were in effect constructive dividends to Ford and that, hence, Ford's gross income for 1970 should be increased by approximately $5.7 million.[268] The figure was computed by taking Transcon's gross underwriting income ($6.4 million) reduced by reinsurance paid ($0.6 million) and premiums paid by certain subsidiaries which had no earnings and profits ($0.1 million).[269]

The IRS challenge of the Ford captive is significant in that Transcon was apparently structured and operated in accordance with usual insurance industry practice. Thus, the case is a good test of whether the economic family[270] theory espoused by the IRS is a sufficient basis to bar the parent a deduction for the premium paid to a captive insurance subsidiary. There is a growing indication, however, that the IRS is now willing to settle the matter out of court.[271]

There are other cases now in litigation. For example, *Carnation Co. v. Commissioner*[272] involves $1,755,000 in premiums for the reinsurance of an independent insurer which was writing the property exposures at 135 United States and Canadian facilities owned by Carnation. The captive reinsured 90% of the first $500,000 of any loss covered by the primary policy. There was no indication that the captive was providing any third-party insurance. Furthermore, its capitalization was only $120,000 in cash with the parent agreeing to purchase 288,000 additional shares at $10 per share upon demand,

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264. *Id.* at 10.

265. *See* text immediately preceding note 256 *supra.*

266. Petition for Appellant at 10, Ford Motor Co. v. Commissioner, *petition docketed,* No. 3660-75 (T.C. Apr. 25, 1975).

267. *Id.*

268. Notice of Deficiency (L-21) from D. Alexander (Comm'r of IRS) to Ford Motor Co. (Jan. 29, 1975) (reference L-21 Code 430) (Explanation of Items (a)).

269. Petition for Appellant at 8-9, Ford Motor Co. v. Commissioner, *petition docketed,* No. 3660-75 (T.C. April 25, 1976).

270. *See* discussion notes 211 & 214 *supra.*

271. The facts in the *Ford* case suggest a captive insurance company whose size and nature of operation make it a formidable one for the IRS to challenge. There is a strong likelihood that the IRS will not litigate the case to completion but will settle out of court. The terms of that settlement are not yet available. *Ford, IRS Near a Settlement,* Bus. Ins., Dec. 26, 1977, at 1, col. 3.

272. Carnation Co. v. Commissioner, *petition docketed,* No. 5793-76 (T.C. June 29, 1976); *see* LeRoux, *Carnation vs. IRS in Key Captive Case,* Bus. Ins., Dec. 27, 1976, at 1, col. 1.

thus giving the captive access to $3,000,000 in capital.[273] These facts suggest that the risk bearing capacity was considerably more limited than was the case in *Ford*. The use of parent guarantees or stock purchase agreements would evidence a lack of risk shifting to the captive. Thus, a decision in *Carnation* contrary to premium deductibility may not be representative of the treatment of other captives.

In summary, the realities of corporate risk management in the 1970's will result in an ever-increasing degree of direct self-assumption of risk. The captive insurance company can serve as a vehicle to effect this result in a cost effective manner. Although abuses are clearly possible, the captive insurance subsidiary should be evaluated as to its bona fide nature on the basis of its financial structure, mix of business, and operating procedures. The IRS challenge rests largely on the contention that risk shifting, a prerequisite for a valid insurance contract, cannot exist among members of the same economic family. It is submitted that this position is too broadly drawn given the existing case law precedents and the legislative intent. If there is an arm's-length insurance company operation, then the entity should be taxed as such and the parent should enjoy the same premium treatment that would result with an independent insurer.

IV. Conclusion

The fundamental purpose of this Comment has been to identify some of the complex problems associated with the income taxation of corporate liabilities. The major distinguishing element among the various risk financing alternatives available is the treatment of the reserves associated with liabilities incurred-but-not-paid. Such reserves have become increasingly significant for modern corporations as a result of the explosion in corporate liabilities and the associated decline in the ability of traditional risk transfer plans through independent insurers to provide an economic vehicle for the financing of such responsibilities.

The requirements of the "all events" test should be aligned with the growing use of self-insurance among corporations. For example, in the various no-fault liability areas, such as workers' compensation, liability is certainly fixed by the physical events of the underlying incidents. A deduction for such liabilities should be permitted in their year of occurrence if the taxpayer can demonstrate a historical ability to estimate such liabilities to within twenty percent of the actual value on an aggregate basis.

A trust as a vehicle for prefunding incurred liabilities can provide a reliable basis to insure that such reserve funds will be available and used for the actual payment of the subject liabilities. While section 461(f) of the Internal Revenue Code of 1954 does provide such a vehicle it is of limited practical value. The regulations should be expanded to permit the size of the trust to be tested on objective grounds (for example, by comparison of its initial size to the amount of actual payments) in addition to the current Code allowances.

273. Petition for Appellant at 3-5, Carnation Co. v. Commissioner, *petition docketed*, No. 5793-76 (T.C. June 29, 1976).

The captive insurance company can be a logical extension of a corporation's risk management program without regard to its potential income tax advantage. As more liberal treatment is afforded self-insurance and trust plans, however, the captive should receive equivalent treatment. The standard for granting a captive the status of a bona fide insurer under Code provisions should be the existence of sufficient independent financial capacity to perform on the accepted risks and an arm's-length operation in accordance with insurance industry practices.

The modern corporation is often viewed as a vehicle for the equitable distribution of the risk of loss associated with their products and operations without regard to negligence or other standards of fault. It is a requirement consistent with this burden that corporations be permitted to match their costs of doing business with the associated revenues within the structure of the income tax law. The increasingly liberal treatment for tax deductibility of those reserves identified in this Comment and the changes recommended where the law is still in a state of development will satisfy an important corporate need. Proper regulation of such reserves (whether in terms of a self-insurance program, trust, or captive insurance company) can be used to insure the protection of the employees or third-parties asserting the liabilities associated with the reserves in issue.

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