"COMMONLY ACCEPTED NOTIONS OF INSURANCE" FOR CAPTIVES IN TAX CASES ARE NOT COMMON NOTIONS OF INSURANCE IN THE INSURANCE INDUSTRY

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INTRODUCTION

Experts in insurance have a hard time defining insurance. The insurance field allows multiple definitions to co-exist in a pragmatic and highly-regulated marketplace. It is an ecosystem of regulations, law, theory, probabilistic mathematics, and economics. The tax courts, deciding tax deduction questions involving premiums paid to captive insurance companies, have settled on their own definition of insurance, which they call

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"commonly accepted notions of insurance."[1] These notions are far removed from the criteria (or notions) known to the insurance domain. In fact, most of the tax notions of insurance are neither common nor even relevant to what insurance is. An incorrect understanding of insurance could be a problem for how the tax courts decide whether the premiums paid to captive insurers are appropriate and deductible business expenses. This article reviews the tax decisions that have led to the mistaken, and in fact not, "commonly accepted notions of insurance." It reviews the history, development, practice, and regulation of insurance to show that a licensed, regulated insurance company can lawfully do far more than what the tax court decisions believe, regardless of whether the insurer is a standard-type corporate insurance company, mutual insurer, surplus lines insurer, or captive insurer. This paper also examines the risk distribution concept and concludes that the great variety in how insurance is actually done as a business shows that risk distribution, as the tax courts use the concept, is sometimes unreliable as a guide to determine the practice of insurance.

I. WHY CAPTIVE INSURANCE COMPANIES ARE A PROBLEM FOR THE IRS

Captive insurers are regulated insurance companies, like any other insurance company, except they are owned by a parent corporation to insure the parent corporation's insurable risks, rather than the insurable risks of individuals and firms outside the corporation.[2] The reasons a corporate parent might form a captive insurance company include "excessive pricing, limited capacity, risks that are uninsurable in the 'traditional' insurance market, or the desire for a more cost-efficient risk financing mechanism."[3] A standard treatise on captive insurance states, "[c]aptive insurance is utilized by insureds that choose to put their own capital at risk by creating

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[1] The phrase appears in several tax court cases. *See, e.g.*, AMERCO & Subsidiaries v. Comm'r, 96 T.C. 18, 42 (1991), *aff'd sub nom.* AMERCO, Inc. v. Comm'r, 979 F.2d 162 (9th Cir. 1992); Harper Grp. & Includible Subsidiaries v. Comm'r, 96 T.C. 45, 60 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992); Rent-A-Ctr., Inc. v. Comm'r, 142 T.C. 1, 13 (2014); Avrahami v. Comm'r, 149 T.C. 144, 181 (2017).

[2] William Byrnes, *Captive Insurance Arrangements, in* 2 NEW APPLEMAN ON INSURANCE LAW § 12.16[1] (Jeffrey E. Thomas & Martin F. Grace eds., Library ed., LEXIS, database updated May 2021).

[3] Stephen T. Bird, *Reasons for Forming a Captive*, INT'L RISK MGMT. INST.: RISK FIN., https://www.irmi.com/online/rf/ch004/1l04h000/al04h001-reasons-for-forming-a-captive.aspx (last visited Jan. 19, 2022).

their own insurance company, or utilizing an existing special purpose insurer, working outside of the commercial insurance marketplace to achieve their risk financing objectives."[4] Teasing this apart shows the following elements are required: (1) that the insured is "willing and able to contribute risk capital;"[5] (2) that the insurer is "working outside of the commercial insurance marketplace"[6] by being owned and controlled by the insured, but is distinguishable from the mutual insurance company where there are many owners with no control; and (3) that the captive is "to achieve their [insured owner's] risk financing objectives."[7] A pure captive insurer is one that writes the risks of the insured, which may include "an unrelated risk to satisfy the risk financing objectives of the owner."[8] Control over the risk financing is fundamental to captives.

> Inevitably, insureds wishing to improve control over the way that insurance is used to finance their risks seek to increase their control over the insurer. This explains why the second essential element of captive insurance is that it involves financing risks using special purpose insurers, companies that operate or provide programs outside of the traditionally regulated commercial marketplace.[9]

Another treatise on captive insurance explains, "[c]aptive insurance is the zenith of risk financing. Captives provide businesses the ultimate flexibility regarding coverage, claims, premium, and control, while further offering a bevy of valuable attributes such as lucrative dividends and innovative financing techniques . . . ."[10]

Setting up, funding, managing, and operating a captive insurer is a complex operation. It is suitable only after a "feasibility study" shows a captive is sensible and management determines it has the capability to run a

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[4] KATHRYN A. WESTOVER, CAPTIVES AND THE MANAGEMENT OF RISK 5 (2nd ed. 2006).

[5] *Id.* at 6.

[6] *Id.*

[7] *Id.* at 7.

[8] *Id.* at 8. Furthermore, such distinction of unrelated risk has some relevance later to challenges by the Internal Revenue Service to captive insurers and the spread of risk. *See infra* Part III.

[9] WESTOVER, *supra* note 4, at 7.

[10] MATTHEW QUEEN & LIGHT TOWNSEND, MODERN CAPTIVE INSURANCE: A LEGAL GUIDE TO FORMATION, OPERATION, AND EXIT STRATEGIES xxi-xxii (2019).

captive insurer (with appropriate managers).[11] There must be financial advantages, such as possible tax advantages, for a business to go through the expense and trouble of using a captive insurer.[12] However, that analysis, and the particulars of the tax aspects, are not relevant to this paper.

The Internal Revenue Service ("IRS") has long challenged the tax deductions made by corporations, big and small, when they deduct the premiums paid to their captive insurance companies.[13] There have been good reasons in some situations for doubting the deductible expenses of insurance premiums paid to captive insurers based on the economic-substance doctrine, which is used to evaluate the transaction.[14] Yet the IRS has often challenged the deductions based on its ideas of what constitutes insurance and what constitutes an insurance company.[15] This is a different problem because captive insurers are established and regulated by state insurance commissioners or off-shore insurance regulators—wherever the parent corporation chooses to set up its captive insurer.[16]

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[11] *See* Stephen T. Bird, *Captive Feasibility Study*, INT'L RISK MGMT. INST.: RISK FIN., https://www.irmi.com/online/rf/ch004/1l04h000/captive-feasibility/bl04h060a-feasibility-studies.aspx (last visited Jan. 19, 2022).

[12] *See* Byrnes, *supra* note 2 ("While the tax benefits of captive insurance are often not the primary motivator for using a captive insurance structure, they can provide motivation for forming a captive instead of using commercial insurance.").

[13] *See generally* Li-Ming Han & Gene C. Lai, *The Tax Deductibility of Premiums Paid to Captive Insurers: A Risk Reduction Approach*, 58 J. RISK & INS. 47 (1991); Philip Garrett Panitz, *Captive Insurance: Avoiding the Risks*, J. OF ACCT. (June 1, 2018), https://www.journalofaccountancy.com/issues/2018/jun/captive-insurance-entities.html.

[14] Salty Brine I, Ltd. v. United States, No. 5:10-CV-108-C, 2013 U.S. Dist. LEXIS 98509, at *43 (N.D. Tex. May 16, 2013); Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 545 (5th Cir. 2009); Frank Lyon Co. v. United States, 435 U.S. 561, 583–84, (1978).

[15] *See generally* Han & Lai, *supra* note 13; Panitz, *supra* note 13.

[16] *See* McCarran-Ferguson Act, 15 U.S.C. §§ 1011–1015. *See also* WESTOVER, *supra* note 4, at 146–47; QUEEN & TOWNSEND, *supra* note 10, at 156–57; Gary M. Cohen, *History of Insurance Regulation, in* 2 NEW APPLEMAN ON INSURANCE LAW § 8.01 (Jeffrey E. Thomas & Martin F. Grace eds., Library ed. 2021). Illustrative statutes of some of the leading state domiciles for captive insurers include VT. STAT. ANN. tit. 8, § 6001(5) (LEXIS through 2021 Adj. Sess.) ("'Captive insurance company' means any pure captive insurance company, association captive insurance company, sponsored captive insurance company, industrial insured captive insurance company, agency captive insurance company, risk retention group, affiliated reinsurance company, or special purpose financial insurance company

The IRS has several criteria to decide whether the captive insurer sufficiently resembles a proper insurance company—where premiums paid to the captive resemble premiums paid to any insurer in order to be deductible as an ordinary business expense. The criteria are: (1) an insurable risk to transfer; (2) risk-shifting; (3) risk-distribution; and (4) insurance "in its commonly accepted sense,"[17] sometimes called "common notions of insurance."[18]

Risk shifting is usually easy enough to find—unless the risk circles back to the parent in a "circular flow of funds."[19] Risk distribution is easy to find when there are a large number of insurable exposures, such as office properties or a fleet of vehicles, but is harder to find for small businesses with few properties or for liability. Also, questions about vertical distribution may exist when reinsurance is used.[20] An examination of how risk distribution actually exists, historically and currently, shows that this is sometimes a difficult concept to properly observe.

"Commonly accepted notions of insurance" sounds sensible, except such notions are limited to the tax cases, not the insurance cases. In fact, the tax case notions are non-existent in the insurance statutes, insurance cases, and the practices of insurance.[21] Moreover, old and new treatises of insurance show a completely different view of the practices of insurance than what the IRS and the tax courts view as insurance.[22]

II. ORIGINS OF THE TAX COURT CRITERIA FOR EVALUATING INSURANCE

The first mention of "commonly accepted notions of insurance" appeared in *Helvering v. Le Gierse*.[23] The case involved a life insurance

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formed or licensed under the provisions of this chapter." (footnote omitted)); COLO. REV. STAT. ANN. § 10-6-103 (LEXIS through 2022 Reg. Sess.); S.C. CODE ANN. § 38-90-10 (LEXIS through 2022 Reg. Sess.); TENN. CODE ANN. § 56-13-101 (LEXIS through 2022 Re. Sess.).

[17] AMERCO & Subsidiaries v. Comm'r, 96 T.C. 18, 38 (1991).

[18] Avrahami v. Comm'r, 149 T.C. 144, 180 (2017).

[19] *See id.* at 185; Rent-A-Ctr., Inc. v. Comm'r, 142 T.C. 1, 11–12 (2014).

[20] *See* 1 GRAYDON S. STARING & DEAN HANSELL, LAW OF REINSURANCE § 1:1 (2022 ed., Westlaw, database updated Mar. 2022) ("Usually only a part of a loss or liability is reinsured. Sometimes, however, it may be the entire loss or liability."). *See also id.* § 1:3 (discussing horizontal and vertical risk distribution).

[21] *See* discussion *infra* Part IV.B.

[22] *See* discussion *infra* Part IV.A.

[23] Helvering v. Le Gierse, 312 U.S. 531 (1941).

company that sold to the taxpayer an unusual combination of an annuity contract and a life insurance policy.[24] The purpose of the policy was, evidently, to generate an annuity payment from the life insurance and then have the unpaid premiums move via life insurance to a beneficiary, and, crucially, avoid that value being included in the gross estate and subject to estate tax.[25] Life insurance has long been used for this precise purpose—to avoid the estate tax and use a life insurance trust to hold the insurance—so long as the purchase is made at least three years in advance.[26] The generation of an annuity payment was a clever idea to allow the decedent to have an income from money that otherwise would be valued in the estate if the insurance proceeds exceeded $40,000 (then the exclusion amount for the estate tax).[27] The Supreme Court found a scant definition of insurance in the tax regulations, and thus, sought alternate definitions.[28] It found that "courts and commentators" agreed that "risk-shifting and risk-distributing are essential to a life insurance contract."[29] Life insurance met those requirements, and thus, it was "'insurance' in its commonly accepted sense."[30] This was all the Supreme Court said about what stands for insurance in the commonly accepted sense. In the particular facts of the case, the Supreme Court found that the combination of the annuity and life

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[24] *Id.* at 536–37.

[25] *Id.*

[26] *See* 3 J. MARTIN BURKE, MICHAEL K. FRIEL, & ELAINE HIGHTOWER GAGLIARDI, MODERN ESTATE PLANNING § 39.10 (2nd ed., LEXIS, database updated May 2022). *See also* 26 U.S.C. § 2042.

[27] *See Helvering*, 312 U.S. at 537–38:

> Section 302 of the Revenue Act of 1926 . . . provides: 'The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible . . . (g) To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.' Thus the basic question is whether the amounts received here are amounts 'receivable as insurance' within the meaning of s[ection] 302(g).

[28] *Id.* at 538.

[29] *Id.* at 539.

[30] *Id.* at 540. The Supreme Court later said the same thing in *Grp. Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 211 (1979), citing to standard insurance treatises but not citing to *Helvering*.

insurance contracts, though separate, "counteracted each other. . . . The fact remains that annuity and insurance are opposites; in this combination the one neutralizes the risk customarily inherent in the other. From the company's viewpoint, insurance looks to longevity, annuity to transiency."[31] The Supreme Court explained:

> Here the total consideration was prepaid and exceeded the face value of the "insurance" policy. The excess financed loading and other incidental charges. Any risk that the prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk as explained above. It follows that the sums payable to a specific beneficiary here are not within the scope of s[ection] 302(g). The only remaining question is whether they are taxable.[32]

The next case also involved a death payment, but there was no life insurer involved to pay the proceeds upon death. In *All v. McCobb*, an executive of the Standard Oil Company of New Jersey received a "'retirement allowance' under an 'Annuity Plan for the Employees of Standard Oil Company (New Jersey) and its Participating Subsidiaries Effective January 1, 1932'"[33] and the employer also provided a death benefit plan for the executives that paid twelve equal payments to the survivor upon the death of the executive.[34] An executive died, the survivor received the extra payments, and the survivor sought to exclude them from the decedent's estate as life insurance proceeds.[35] The IRS contested the exclusion.[36] The Supreme Court agreed with the commissioner that because there was no insurance involved and no premium was paid, the proceeds did not exceed any premium (of which there was none), and these were extra payments made by the employer.[37]

> The decedent in no way shifted to the company the risk that his death would come prematurely and before the company,

[31] *Helvering,* 312 U.S. at 541.
[32] *Id.* at 542.
[33] All v. McCobb, 321 F.2d 633, 634 (2d Cir. 1963).
[34] *Id.*
[35] *Id.* at 635.
[36] *Id.*
[37] *Id.* at 637.

> as insurer, had received premiums by or on his account in a sum equal to the amount required to be paid to the beneficiary. The company in no way gambled with the decedent that he would live a long life and that it would recover by periodic assessments before his death the amount to be paid to the beneficiary. It made no difference to the company, so far as any fund was concerned, whether the decedent died prematurely or not.[38]

Later cases citing to *Le Gierse* also considered the estate tax.[39]

The tax court inquiry into what is insurance changed from life insurance to bail bonds in *Allied Fidelity Corp. v. Commissioner*.[40] The court considered whether a bail bond company was an insurance company for purposes of whether to classify its expenses and reserves as deductible or excludable expenses.[41] The problem was whether bail bonds were close enough to surety bonds, because surety is a type of insurance. This raised the question of what insurance was. The court stated it lacked any place to look for that definition of insurance for tax purposes, and even outside of the tax law there were varied definitions.[42]

> We are provided with no helpful, freestanding definitions of the terms 'insurance' and 'insurance company' for Federal tax purposes. It is clear that our decision is not controlled by nontax classifications and that characterization of particular corporations depends not on labels or certificated powers but on the character of the business actually conducted and that, in the absence of other guides, we should presume Congress to have used words in their ordinary and commonly understood sense. . . .

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[38] *Id.*

[39] *See, e.g.*, Proutt's Est. v. Comm'r, 125 F.2d 591 (6th Cir. 1942) (life insurance); United States v. First Nat'l Bank & Trust Co. of Minneapolis, 133 F.2d 886 (8th Cir. 1943) (life insurance); Cary v. United States, 141 F. Supp. 750 (D. Neb. 1956) (health insurance); Edgar v. Comm'r, 39 T.C.M (CCH) 816 (1979) (life insurance); *In re* Newton's Estate, 32 N.Y.S.2d 473 (N.Y Sur. Ct. 1941) (life insurance).

[40] Allied Fid. Corp. v. Comm'r, 66 T.C. 1068 (1976), *aff'd*, 572 F.2d 1190 (7th Cir. 1978).

[41] *Id.*

[42] *Id.* at 1073.

> In resolving this issue, we are unable to ascribe much significance to the fact that AFIC's bail bonding business was subject to regulation under the insurance laws of the various States in which it did business. Such regulation amounts to no more than a recognition that a corporate bail bondsman is ordinarily an insurance or surety company, not that bail bonding is insurance. . . .
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> In common understanding, an insurance contract is an agreement to protect the insured (or a third-party beneficiary) against a direct or indirect economic loss arising from a defined contingency. . . . By contrast, the principal obligation of the bail surety at common law was to produce the defendant at trial, an obligation for which the monetary bond was merely an assurance of, or inducement to, performance.[43]

The court concluded that bail bonds were not insurance, even though bail bond companies were regulated as insurers.[44] This is because:

> The focus of the bail system remains on balancing the accused's interest in personal liberty against the giving of adequate assurance of his presence during the criminal proceedings not on protecting the Government against economic loss. Thus, the surety is still regarded as contracting principally to assume the Government's duty of supervising the defendant, rather than to compensate it for an economic loss.[45]

Later tax opinions upheld this ruling but recognized that surety companies are insurance.[46]

It is from these tax cases, usually involving life insurance as noted earlier, that the IRS and the tax courts made the leap to what is insurance for property and liability exposures and what constitutes insurance for a property and casualty insurer. This is a big leap, and it does not land well.

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[43] *Id.* at 1073–74 (citations omitted).

[44] *Id.* at 1076.

[45] *Id.* at 1075 (citation omitted).

[46] *See* I.R.S. Gen. Couns. Mem. 39,154 (Mar. 1, 1984); I.R.S. Tech. Adv. Mem. 84-06-001 (Mar. 11, 1983).

III. THE CAPTIVE INSURANCE CASES' USE OF "COMMONLY ACCEPTED NOTIONS" TO DETERMINE INSURANCE

The expansion in the use of captive insurance companies in the 1990's led to some questionable uses of tax deductions by the parent corporations.[47] The IRS challenged these and were sometimes successful. Part of the challenge was to determine whether these captive insurance companies really were operating as an insurer for the parent corporation. The IRS and the tax courts then examined whether the captives were actually doing insurance—despite the fact that insurance regulatory bodies onshore and offshore had licensed, allowed, supervised and regulated these companies to operate as insurance companies. The IRS and the tax courts disregarded the de facto insurance license and regulatory approval, and instead looked back at earlier court decisions that tried to define insurance. Remember, those earlier decisions were primarily in the life insurance context and mostly dealt with gross estate value determinations for estate taxes. As will be shown below, this led to some questionable tax case law in the property and casualty sector where many captive companies operate[48]—decisions that are contrary to actual insurance law and practices.

AMERCO v. Commissioner was the first of the captive insurance cases that sought to create its own interpretation of insurance. The court acknowledged that *Le Gierse* was the wrong place for a definition of insurance.[49]

> We begin our discussion with the genesis of the law in this area, *Helvering v. LeGierse*, 312 U.S. 531 (1941). It must be noted that LeGierse was not a captive insurance case; it rather construed and applied the phrase "receivable as insurance" within the meaning of section 302(g) of the Revenue Act of 1926, an estate tax exclusion for life insurance proceeds. Its insights are important, however, because it addressed a statutory void which persists today: the lack of any statutory definition of the term "insurance."

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[47] In some cases, the tax opportunities drove the use of the captives rather than the feasibility of captives.

[48] Captives can and do operate in other insurance sectors, providing coverage for employee benefit plans, medical stop-loss programs, and some unusual coverages that are not easily slotted within property and casualty insurance.

[49] AMERCO & Subsidiaries v. Comm'r, 96 T.C. 18, 37–38 (1991).

> . . . .
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> Three basic points are made above: (1) that an insurance transaction must involve "insurance risk;" (2) that insurance involves risk-shifting and risk-distributing; and (3) that, in the absence of a statutory definition, "insurance" is to be defined in its commonly accepted sense. We supplement these insights with another tenet, basic to all our decisions: that matters of Federal income taxation must be resolved with principles of Federal income taxation borne in mind.
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> These four principles do not yield a definition of insurance. They do, however, create what we believe is the proper framework to be adopted when addressing a question of the existence of insurance for Federal tax purposes. They are not independent or exclusive. Instead, we read them as informing each other and, to the extent not fully consistent, confining each other's potential excesses.[50]

The court then acknowledged that while the states regulate insurance and that the insurer in this case was licensed by that state, that was not "dispositive."[51] *AMERCO* was the fount for the rest of the captive cases.

Harper Group v. Commissioner was another case involving a business that had a property and casualty insurance subsidiary licensed and

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[50] *Id.* (citations omitted).

[51] *Id.* at 42. The Court also stated:

> We think that the technical indicia of insurance discussed above, supplemented by our analysis of the substance of the transactions at issue, combine to create insurance in the commonly accepted sense. Under this rubric we emphasize the state regulators' definitions of Republic Western as a fully licensed property and casualty insurer, and of the transactions at issue as insurance. While these definitions are not dispositive of the issue before us, they do inform our decision. We note that Congress has delegated to the states the exclusive authority (subject to exception) to regulate the business of insurance.

Id. (citing McCarran-Ferguson Act, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011–1015)). *See also In re* Stewart's Shops Corp., DTA No. 825745, 2016 WL 1086062, at *21 (N.Y. Div. Tax. App. Mar. 10, 2016).

regulated, however this one in Hong Kong.[52] Again, the court recognized that the company was conducting insurance sufficient for the tax deduction of the corporate parent's premium.[53] *Harper* seems to have created the factors used to determine what is "insurance in its commonly accepted sense" (as contemplated by the tax courts).

> Rampart was both organized and operated as an insurance company. It was regulated by the Insurance Registry of Hong Kong. The adequacy of Rampart's capitalization is not in dispute. The premiums charged by Rampart to its affiliates, as well as to its shippers, were the result of arm's-length transactions. The policies issued by Rampart were valid and binding. In sum, such policies were insurance policies, and the arrangements between the Harper domestic subsidiaries and Rampart constituted insurance, in the commonly accepted sense.[54]

The insured in *Sears, Roebuck & Co. v. Commissioner* sought to deduct loss reserves on mortgage insurance. [55] The related corporate insurer was a subsidiary of the well-known insurer, Allstate Insurance Company, then itself a subsidiary of Sears.[56]

> Allstate is a substantial underwriter, collecting more than $5 billion in premiums annually and possessing more than $2 billion in capital surplus. During the years at issue, Allstate charged Sears approximately $14 million per year for several kinds of insurance. Some 99.75% of Allstate's

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[52] Harper Grp. & Includible Subsidiaries v. Comm'r, 96 T.C. 45, 47–48 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992).

[53] *Id.* at 60.

[54] *Id.*

[55] Sears, Roebuck & Co. v. Comm'r, 972 F.2d 858, 859–60 (7th Cir. 1992). Of note, this case was different from most of the other captive cases that involved deductibility of premiums paid by the parent.

[56] *Id.*

> premiums came from customers other than Sears, which places 10% to 15% of its insurance with Allstate.[57]

As to the meaning of insurance, the court discounted the applicability of the *Le Gierse* definition.

> What is "insurance" for tax purposes? The Code lacks a definition. *Le Gierse* mentions the combination of risk shifting and risk distribution, but it is a blunder to treat a phrase in an opinion as if it were statutory language. The Court was not writing a definition for all seasons and had no reason to, as the holding of *Le Gierse* is only that paying the "underwriter" more than it promises to return in the event of a casualty is not insurance by any standard.[58]

In fact, "[t]he experts who labored during this trial to define 'insurance' all would have agreed that this dispute is an artifact of the

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[57] *Id.* at 860. Some useful history of why this tax challenge evolved is stated in the opinion.

> Allstate, founded in 1931, has been selling insurance to Sears since 1945. Everyone, including the Commissioner, has taken Allstate as the prototypical non-captive insurance subsidiary. Until 1977 the Internal Revenue Service respected transactions between non-captive insurers and their parents. In that year the Commissioner decided that a wholly owned subsidiary cannot "insure" its parent's operations, even if the subsidiary's policies are identical in terms and price to those available from third parties. Examples given in this revenue ruling all dealt with captives that had no customers outside the corporate family. After issuing the ruling the Service continued to believe that subsidiaries engaged in "solicitation and acceptance of substantial outside risks" could provide insurance to their parents. But in 1984 the General Counsel reversed course and the Commissioner later announced that all wholly owned insurance subsidiaries should be treated alike. Our task is to decide whether this is correct. We therefore disregard details, which may be found in the Tax Court's opinion. Like the Commissioner, we deem immaterial the nature of the risks Allstate accepted, the terms the parties negotiated, and the precise deductions taken.

Id. at 860–61 (citations omitted).

[58] *Id.* at 861 (citations omitted).

corporate income tax, which by divorcing taxation from real persons' wealth, income, or consumption is bound to combine tricky definitional problems with odd incentives."[59]

The court in *Securitas Holdings, Inc. v. Commissioner* took the *Harper* list and created formal factors to determine "insurance in the commonly accepted sense": "(1) the insurer was organized, operated, and regulated as an insurance company; (2) the insurer was adequately capitalized; (3) the insurance policies were valid and binding; (4) the premiums were reasonable; and (5) the premiums were paid and the losses were satisfied."[60]

Rent-A-Center, Inc. v. Commissioner involved workers' compensation, automobile, and general liability insurance, for thousands of stores and approximately 20,000 employees and 8,000 vehicles.[61] The court cited to the *Harper* factors but decided the case on the obvious risk distribution of all these thousands of insurable exposures.[62]

Avrahami v. Commissioner was a little different because it was a section 831(b) captive that had several signs of concern about how and whether its insurance captive was actually performing insurance.[63] The commonly accepted factors the court used were:

> [W]hether the company was organized, operated, and regulated as an insurance company; whether the insurer was adequately capitalized; whether the policies were valid and binding; whether the premiums were reasonable and the result of an arm's-length transaction; and whether claims were paid. We have also looked at whether the policies covered typical insurance risks and whether there was a legitimate business reason for acquiring insurance from the captive.[64]

Reserve Mechanical Corp. v. Commissioner was also a section 831(b) captive that provided excess insurance over multiple commercially purchased insurance policies and non-standard property policies such as loss of a major customer, weather-related business interruption, tax liability, etc.,

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[59] *Id.* at 864.

[60] Securitas Holdings, Inc. v. Comm'r, 108 T.C.M. (CCH) 490, 2014 T.C.M. (RIA) ¶ 2014-225, slip op. at 27 (2014).

[61] Rent-A-Ctr. v. Comm'r, 142 T.C. 1, 24 (2014).

[62] *Id.* at 13.

[63] Avrahami v. Comm'r, 149 T.C. 144 (2017).

[64] *Id.* at 191 (citations omitted).

all for a $448,127 premium in 2009.[65] It again formalized the factors to determine insurance in the "commonly accepted sense."[66]

> (1) [W]hether it was created for legitimate nontax reasons;
> (2) whether there was a circular flow of funds;
> (3) whether the entity faced actual and insurable risk;
> (4) whether the policies were arm's-length contracts;
> (5) whether the entity charged actuarially determined premiums;
> (6) whether comparable coverage was more expensive or even available;
> (7) whether it was subject to regulatory control and met minimum statutory requirements;
> (8) whether it was adequately capitalized; and
> (9) whether it paid claims from a separately maintained account.[67]

The court in *Syzygy Insurance Co. v. Commissioner* restated its own factors, mostly based on the non-captive case *R.V.I. Guaranty Co. & Subsidiaries v. Commissioner*,[68] but harking back to the *Harper* case: "(1) whether the company was organized, operated, and regulated as an insurance company; (2) whether it was adequately capitalized; (3) whether the policies were valid and binding; (4) whether premiums were reasonable and the result of arm's-length transactions; and (5) whether claims were paid."[69]

Other cases that deal with this question of "commonly accepted notions of insurance are *Kidde Industries, Inc. v. United States*[70] and *Malone*

[65] Rsrv. Mech. Corp. v. Comm'r, 115 T.C.M. (CCH) 1475, 2018 T.C.M. (RIA) ¶ 2018-086, slip op. at 18 (2018), *appeal docketed*, No. 18-9011 (10th Cir. Dec. 27, 2018).

[66] *See id.* at 48–49.

[67] *Id.* at 38–39.

[68] R.V.I. Guar. Co. & Subsidiaries v. Comm'r, 145 T.C. 209 (2015). *See infra* text accompanying notes 73–75.

[69] Syzygy Ins. Co. v. Comm'r, 117 T.C.M. (CCH) 1165, 2019 T.C.M. (RIA) ¶ 2019-034, slip op. at 37 (2019).

[70] Kiddie Indus., Inc. v. United States, 40 Fed. Cl. 42, 51 (Fed. Cl. 1997), *dismissed*, 194 F.3d 1330 (Fed. Cir. 1999).

& Hyde, Inc. v. Commissioner.[71] Several state court tax cases involving captives also used the commonly accepted notions criteria.[72]

The aforementioned non-captive case, *R.V.I.*, took the *Harper* factors, and then (unusually) looked at various state definitions of insurance (including Pennsylvania, Arizona, New York, and Washington) to decide

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[71] Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835, 839 (6th Cir. 1995).

[72] *See, e.g.*, New York *ex rel.* Banerjee v. Moody's Corp., 50 N.Y.S.3d 28 (N.Y. Sup. Ct. 2016); *In re* Stewart's Shops Corp., DTA No. 825745, 2016 WL 1086062, at *21 (N.Y. Div. Tax. App. Mar. 10, 2016);

> Addressing the second criterion, I find that the arrangement meets commonly accepted notions of insurance. Petitioner presented convincing evidence that BRIC was a bona fide insurance company. In forming BRIC, petitioner made a business decision premised on legitimate nontax considerations, including the desire to reduce insurance costs, obtain otherwise unavailable insurance coverage, increase incentive for risk management, and more efficiently manage and control its insurance program. BRIC was formed consistent with the New York Insurance Law and was licensed and regulated by the Insurance Department. Petitioner engaged PWC to assist in the formation and license application of BRIC, and to prepare a feasibility and actuarial study. In preparing the study, PWC reviewed petitioner's historic insurance policies and its loss history and proposed lines of insurance that BRIC should provide and amounts of premiums that should be charged for those lines on insurance. After BRIC was licensed, its captive manager finalized the lines of insurance BRIC would provide to petitioner, and determined the premiums to be charged based on the PWC study, petitioner's historical insurance needs and losses, market rates and industry standards for similar lines of insurance provided by other companies. At the end of each year, BRIC engaged AON to conduct an actuarial review of BRIC's operations. BRIC's captive manager annually reevaluated the lines of insurance and premiums based on the AON actuarial report, market rates and industry standards. BRIC reviewed and investigated claims submitted by petitioner, determined whether to approve or deny the claim, and paid claims from a separately maintained account. BRIC was adequately capitalized. Based on the foregoing, the evidence supports the conclusion that BRIC was a bona fide insurance company and the arrangement meets the commonly accepted notions of insurance.

In re Stewart's Shops Corp., DTA No. 825745, 2016 WL 1086062, at *21 (N.Y. Div. Tax. App. Mar. 10, 2016) (citations omitted).

whether this particular type of insurance—"residual value insurance"—was insurance.[73] Based on the state definitions, the court found the captive was insurance.[74] Impressively, the court—and only this court—referred to various insurance treatises to confirm that the insurance here was insurance.[75]

Except for *R.V.I.*, the preceding cases attempted to define insurance in the "commonly accepted sense." They started with an innocuous and vague statement from a life insurance and estate case, to accrete various non-technical ideas of insurance that resulted in a formal criterium for how tax law views insurance. This view of insurance differs from that of the insurance industry and insurance law.

IV. HOW INSURANCE VIEWS NOTIONS OF INSURANCE

An old law review Note on how insurance is defined, cited in *Allied Fidelity Corp.*,[76] cautioned on the efforts to classify insurance in different subjects:

> The meaning of the terms "insurance" and "insurance corporation" may differ considerably with the purposes for which the question is sought to be determined. Cases of one type may not be precedents for a case of a different type. In each case the purpose of the law involved, the powers and activities of the company, and the state's classification of the company, should be fully scrutinized to the end that the determinations in one field do not confuse the issues in another.[77]

As often happens, definitions are appropriate for core principles, but then practice outruns definitions and theory. Certainly, insurance involves

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[73] *R.V.I. Guar. Co.*, 145 T.C. at 237–39.

[74] *Id.* at 246 ("Our analysis of insurance risk, risk transfer, risk distribution, and the commonly accepted notions of insurance convinces us that the RVI policies are 'insurance contracts' for Federal income tax purposes.").

[75] *Id.* at 240 (discussing 1 STEVEN PLITT, DANIEL MALDONADO, JOSHUA D. ROGERS & JORDAN PLITT, COUCH ON INSURANCE (3d ed. 2015) and NEW APPLEMAN ON INSURANCE LAW (Jeffrey E. Thomas et al. eds., Library ed. 2015)).

[76] Allied Fid. Corp. v. Comm'r, 66 T.C. 1068, 1073 (1976), *aff'd*, 572 F.2d 1190 (7th Cir. 1978).

[77] Note, *An Analysis of "Insurance" and "Insurance Corporation"*, 36 COLUM. L. R. 456, 472 (1936) (footnotes omitted).

risk transfer and risk distribution, and only corporations licensed and regulated as insurers can sell and transact insurance. Scholars and writers on insurance have long struggled to explain insurance beyond the core. This should induce caution by non-insurance practitioners and judges to not project their own common notions of what is insurance into the insurance field.

A. THE TREATISES TRY TO EXPLAIN WHAT IS INSURANCE

A review of many insurance treatises, old and new, finds some common definitions of insurance and then much resignation that the definitions do not always fit the practice. No definitions refer to "common notions of insurance" as a basis for concluding whether insurance is being practiced.

A well-known insurance treatise, *Couch on Insurance*, provides this statement on trying to define insurance:

> Insurance has been defined in numerous ways, but these variations are primarily semantic. Essentially, insurance is a contract by which one party (the insurer), for a consideration that usually is paid in money, either in a lump sum or at different times during the continuance of the risk, promises to make a certain payment, usually of money, upon the destruction or injury of "something" in which the other party (the insured) has an interest.[78]

This is the transfer of risk. "The primary requisite essential to a contract of insurance is the assumption of a risk of loss and the undertaking to indemnify the insured against such loss."[79] The treatise also looks to various definitions by the courts to add more aspects to the definitions.

> Other common definitions of insurance are (1) a contract to pay a sum of money upon the happening of a particular event or contingency; (2) indemnity for loss in respect of a specified subject by specified perils; (3) an undertaking by one party to protect another party from loss arising from

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[78] 1 STEVEN PLITT, DANIEL MALDONADO, JOSHUA D. ROGERS & JORDAN R. PLITT, COUCH ON INSURANCE § 1:6 (3d ed., Westlaw, database updated Dec. 2021) (footnotes omitted).

[79] *Id.* § 1:9 (footnotes omitted).

> named risks, for the consideration and upon the terms and under the conditions recited; (4) a contractual security against anticipated loss where the risk of loss is occasioned by some future or contingent event and is shifted to or assumed by the insurer, with a distribution of the risk of loss by the payment of a premium or other assessment into a general fund; (5) a contract whereby one party promises for a consideration to indemnify the other against certain risks; and (6) a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from an unknown or contingent event.[80]

Another standard modern insurance treatise is *Appleman on Insurance*, both the original and the current editions. The current edition, *New Appleman on Insurance Law*, has a fine essay on this topic by Robert H. Jerry, II, titled *What is Insurance*.[81] Jerry says "[t]hree concepts are central to an insurance contract: risk; risk transference; and risk distribution."[82] This analysis of insurance matches how the tax cases have defined insurance.

> A contract of insurance is an agreement in which one party (the insurer), in exchange for a consideration provided by the other party (the insured), assumes the other party's risk and distributes it across a group of similarly situated persons, each of whose risk has been assumed in a similar transaction. As this amplified definition indicates, insurance contracts involve an exchange of premium for the promise to assume risk, along with a distribution of the risk across similarly situated insureds. In this definition, "risk" connotes uncertainty in the sense that the loss must be one that is uncertain to occur or unpredictable and outside the substantial control of the parties to the contract.[83]

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[80] *Id.* § 1:6 (footnotes omitted).

[81] Robert H. Jerry, II, *Defining Insurance, in* 1 NEW APPLEMAN ON INSURANCE LAW ch. 1 (Jeffrey E. Thomas & Francis J. Mootz eds., Library ed., LEXIS, database updated May 2022).

[82] *Id.* § 1.03[1].

[83] *Id.* § 1.03[2] (footnotes omitted).

Jerry then looks at state insurance statute definitions,[84] and a 1939 case,[85] to expand further on the position that indemnity alone is not insurance—there must be a "principal object and purpose" to transfer risk in exchange for a payment.[86] Jerry goes back to an earlier version of the *Appleman* encyclopedia for a way to define insurance.

> Courts should examine each commercial transaction to determine if the discrete transaction ought to be regulated in the public interest as the business of insurance. . . . Pursuant to this supplemental test, courts should minimally make the following inquiries.
>
> (1) What is the private interest sought to be protected in the commercial transaction? (Matters, such as insurable interest and risk of harm to that interest, under traditional definitions are evaluated here.)
>
> (2) Who is the party assuming the risk transferred? Is the protected interest indigenous to that party? (Arguably, there is more need for regulation if the assuming party is an independent, for-profit entity promising indemnity against certain risks to the insurable interest.)
>
> (3) Is the protected interest indigenous to the state and all its citizens? (Manifestly, a state and its citizens have a common indigenous interest in safety and health, including the delivery and quality of medical care, safe cars, well-built homes, and the like. Other interests may not be indigenous.)
>
> (4) Does the value of the indigenous interest invoke the purposes and policies of state insurance regulation for all its citizens? (Many reasons justify state insurance regulation, for example: to assure solvency, to assure fairness in rates and rating classifications, and to prevent contractual over-

[84] *See, e.g.*, CAL. INS. CODE § 22 (Deering, LEXIS through 2022 Reg. Sess.); W. VA. CODE ANN. § 33-1-1 (LEXIS through 2022 Legis.); KY. REV. STAT. ANN. § 304.1-030 (LEXIS through 2022 Legis.); WIS. STAT. ANN. § 600.03(25)(a) (LEXIS through 2021-2022 Legis.); MINN. STAT. ANN. § 60A.02 (LEIXS through 2022 Reg. Sess.); ME. REV. STAT. ANN. tit. 24-A, § 3 (LEXIS through 2021 First Reg. Sess.).

[85] Jordan v. Grp. Health Ass'n, 107 F.2d 239 (D.C. Cir. 1939).

[86] Jerry, *supra* note 81, § 1.03[3][b][ii].

> reaching. These concerns are addressed in this final question.)[87]

The prior *Appleman* series (to which Jerry refers) also had a chapter on defining insurance, and mostly gave up trying to do so, calling it "futile."[88]

> For competent insurance lawyering, one must understand that the subject has no useful, or fixed definition. There is neither a universally accepted definition or concept of "insurance" nor a exclusive concept or definition that can be pervasively applied in insurance lawyering. The question "What is Insurance?" arises in sundry lawyering operations and the contexts in which it arises may give rise to differing meanings. For instance, an evaluation of the discrete transaction's social and economic implications is usually significant in divining a definition. Moreover, the discrete circumstances may necessitate a more specialized definition. It would be foolhardy to state here what may seem to be a clear, comprehensive answer to the question: "What is Insurance?" As Learned Hand might observe, any universal definition for the term "insurance" would be "mythically prolix, and fantastically impractical." Thus, in our intricate and evolving commercial and social intercourse, it seems appropriate that any concept and meaning of insurance be sufficiently broad and flexible to meet the varying and innovative transactions which humankind perpetually produces. Understanding that the quest for a single, comprehensive definition is futile, let us undertake the quest to obtain the best comprehensive understanding we can.[89]

Thereafter, the discussion goes to risk and risk sharing.

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[87] Jerry, *supra* note 81, § 1.03[3][b][iv] (quoting 1 ERIC MILLS HOLMES, APPLEMAN ON INSURANCE LAW & PRACTICE § 1.3 (2d ed., LEXIS, database updated Jan. 2010)).

[88] 1 HOLMES, *supra* note 87, § 1.3.

[89] *Id.*

> Risk sharing connotes not only a transfer of risk (risk-shifting) to others but a distribution (sharing) of the risk among the others. All contracts allocate and shift risks. An insurance contract differs from the ordinary contract because of risk distribution. In the insurance contract, the risk of an actual loss is distributed (socialized) among a large group of persons exposed to a comparable risk of loss.[90]

This sounds right, and relevant to captive insurance cases, except that the insured's transfer of risk to a commercial insurer does not actually distribute that risk to others; rather, that risk is held and borne by the commercial insurer. In a mutual insurer, it *might* be said that the risk is transferred to others. Or it can be more accurately said that the insured's risk is transferred to others only if the mutual insurer is an assessment mutual insurer that can charge back to the members any deficiency in capital to pay for an insured's loss.[91] A tax court example of this is *Commissioner v. Treganowan,* which found the New York Stock Exchange's gratuity fund that all members were required to pay in, and which would pay $20,000 death benefits for any member who died, was insurance.[92]

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[90] *Id.*

[91] "Assessment mutual insurance companies do not require the policyholder to pay an advance premium; instead, the policyholder is liable to pay its share of the insurance company's losses and expenses at the end of each insurance period. Assessment mutual companies write a relatively small amount of insurance." 1 LINDA H. LAMEL, BUSINESS INSURANCE LAW AND PRACTICE GUIDE § 1.01[3][b] (LEXIS, database updated June 2022). "Assessment contracts are written either with limited or unlimited rights of assessment against the insureds. A member who belongs to an insurer in which liability is unlimited is bound to pay a proportional share of all the losses and legitimate expenses of the company." 3 PLITT, MALDONADO, ROGERS & PLITT, *supra* note 78, § 39:17. "A mutual insurance company is a cooperative enterprise wherein the policyholders, as members, are both insurer and insured. As members, each policyholder is liable for his proportionate share of indebtedness upon the insolvency of the company." Commonwealth v. Bankers Mut. Fire Ins. Co. of Lancaster, Pa., 45 Pa. D. & C.2d 558, 560–61 (Pa. C.P. 1968) (citations omitted).

[92] *See* Comm'r v. Treganowan, 183 F.2d 288, 291 (2d Cir. 1950):

> Here the risk of loss from premature death is effectively shifted from the individual to the group of other members of the Exchange. If the individual member dies prematurely, the amount

Similarly, in a risk retention group the risk is borne by others in the group.[93] The idea of risk distribution really means, then, that we all share in paying a small premium because everyone's small premium is available to pay for everyone else's occasional and actuarially-predicable loss.

After reviewing state statutes on the definition of insurance, *Appleman* concludes, "it is no facile matter to frame a definition which states accurately and plainly the common features of the enterprises that are generally regarded as subject to 'insurance' regulation."[94] Except, as *Appleman* concluded "[t]he rub is that such a definition may not be possible."[95]

In the next section, the author—after disclaiming the ability to define insurance "for universal application or state a conclusive test"[96]—proposes three dimensions to evaluate whether insurance exists in the transaction. The first dimension is the "substantial control test."[97]

> This traditional test was the earliest adopted by courts. The test conforms to the classical definition of insurance as an arrangement for transferring and distributing the risk of loss upon the happening of a fortuitous event. . . . The test derives from [a] . . . description of an insurance contract . . . as having the following five elements:
>
> (a) The insured possesses an interest of some kind susceptible to pecuniary estimation, and known as an insurable interest;

> paid in, the difference representing the loss caused by his premature death which the group has had to bear. Had he not been a member of the plan, he would have saved the amount of assessments against him before his death, but his beneficiaries would be $20,000 poorer. Thus they would have borne this loss which, through the Exchange plan, he has shifted to the group. And manifestly this plan provides a distribution of the risk, for because of the plan the risk of premature death is borne by the 1373 other members of the Exchange, rather than by the individual.

[93] *See, e.g.*, N.Y. INS. LAW § 5902 (McKinney, Westlaw through 2022 Legis.); CONN. GEN. STAT. § 38a-250 (West, Westlaw through 2022 Reg. Sess.).

[94] 1 HOLMES, *supra* note 87, § 1.3.

[95] *Id.*

[96] *Id.* § 1.4.

[97] *Id.*

> (b) The insured is subject to a risk of loss through the destruction or impairment of the insurable interest by the happening of certain designated fortuitous perils (today generally called the insured event);
>
> (c) The insurer assumes that risk of loss (which today we describe as risk transference);
>
> (d) The insurer assumes that risk as part of a general scheme to distribute actual losses among a large group bearing somewhat similar risks; and,
>
> (e) As consideration for the insurer's promise to assume the risk of loss, the insured makes a contribution (called a premium) to the general insurance fund ((d) and (e) constitute risk distribution).[98]

The second dimension to evaluate whether the transaction involves insurance is the "principal object or ancillary test."[99] "If 'insurance' is the dominant feature (the "basis of the bargain"), then the transaction ought to be defined and regulated as insurance. Contrawise, courts will tolerate a marginal, 'insurance kicker' element, provided that element is relatively insignificant and incidental to the principal objective of the commercial transaction."[100] That means, "[i]n sum, the generally prevailing test today starts with the control (fortuitous) test and then evaluates the insurance element to determine if it is marginal (incidental, ancillary) or predominant."[101]

The third dimension to use is the "regulatory value test," meaning, "[c]ourts should examine each commercial transaction to determine if the discrete transaction ought to be regulated in the public interest as the business of insurance."[102]

As to principal purpose, consider extended warranty and home protection contracts (also known as home warranty contracts) as examples of what the contract really is about. These contracts promise to make repairs to a vehicle or a home and its appliances in exchange for a fixed annual fee. The California legislation specifies that the commercial contracts are not insurance but are their own class of home protection companies licensed as

[98] *Id.* (footnote omitted).
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.*

such,[103] and this comports with the standard purpose of insurance to pay for a loss, not to do actual repairs.[104] Florida also views home warranty contracts as distinct from insurance.[105] In contrast, Virginia seems to interpret these types of contracts as insurance.[106] *Couch on Insurance* says:

> In some states, the legislature has specifically amended the relevant statutes to bring automobile dealers offering extended service contracts within the scope of state insurance regulators. As a general statement, a warranty that covers the goods sold for defects that likely existed in the goods at the time of sale is not an insurance contract, while a warranty that goes materially beyond the goods, or beyond defects in the goods, to compensate for losses due to causes

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[103] CAL. INS. CODE § 12744 (Deering, LEXIS through 2022 Reg. Sess.); CAL. INS. CODE § 12745 (Deering, LEXIS through 2022 Reg. Sess.).

[104] *See* CAL. INS. CODE § 12740(a) (Deering, LEXIS through 2022 Reg. Sess.):

> "Home protection contract" means a contract or agreement whereby a person, other than a builder, seller, or lessor of the home which is the subject of the contract, undertakes for a specified period of time, for a predetermined fee, to repair or replace all or any part of any component, system or appliance of a home necessitated by wear and tear, deterioration or inherent defect, arising during the effective period of the contract, and, in the event of an inspection conducted pursuant to subdivision (b) of Section 12761, by the failure of that inspection to detect the likelihood of any such loss.

The court in Chu v. Old Republic Home Prot. Co., 274 Cal. Rptr. 3d 528, 532 (Ca. Ct. App. 2021), *reh'g denied (*Ca. Ct. App. 2021), *rev denied* (Ca. Ct. App. 2021), recounted the history of this statute:

> The initial draft of the senate bill . . . would provide for the regulation of persons engaged in the sale of home maintenance contracts '*as insurers*, subject to specified provisions of the Insurance Code.' . . .
>
> The final version of the bill . . . however, deleted the references to insurers and insurance, and instead referred to home maintenance or warranty contracts as 'home protection contracts.'

[105] FLA. STAT. ANN. § 634.301 (West, Westlaw through 2022 Reg. Sess.).

[106] VA. CODE ANN. § 38.2-2613 (LEXIS through 2022 Reg. Sess.); VA. CODE ANN. § 38.2-129 (LEXIS through 2022 Reg. Sess.).

> unrelated to the general merchantability of the goods is an insurance contract. . . .
>
> . . .
>
> Even a warranty that does extend to losses beyond defects in the product itself may escape characterization as insurance if the element of "risk transfer" involved is sufficiently incidental to the primary purpose of the contract.[107]

It may also be useful to compare this concept with the determination of whether a contract is for the sale of goods sufficient to come within the Uniform Commercial Code ("UCC") or a sale of services where the goods are ancillary. When the dominant purpose of a contract is the sale of goods, the UCC applies.[108]

The National Association of Insurance Commissioners defines insurance as "an economic device transferring risk from an individual to a company and reducing the uncertainty of risk via pooling."[109] Similarly, the Commission on Insurance Terminology of the American Risk and Insurance Association in 1965 defined insurance as "the pooling of fortuitous losses by transfer of such risks to insurers, who agree to indemnify insureds for such

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[107] 1 PLITT, MALDONADO, ROGERS & PLITT, *supra* note 78, § 1:20 (footnotes omitted).

[108] *See, e.g.*, KSW Mech. Servs. v. Johnson Controls, Inc., 992 F. Supp. 2d 135, 141 (E.D.N.Y. 2014) ("Contracts for goods which involve—incident to the sale of goods—services such as installation, maintenance, testing, instruction or supervision are still subject to the UCC."); Accessory Overhaul Grp., Inc. v. Mesa Airlines, Inc., 994 F. Supp. 2d 1296, 1301 (N.D. Ga. 2014) ("When the predominant element of a contract is the sale of goods, the contract is viewed as a sales contract and the UCC applies, even though a substantial amount of service is to be rendered in installing the goods."); Belleville Toyota, Inc. v. Toyota Motor Sales, U.S.A., Inc., 770 N.E.2d 177, 194 (Ill. 2002) ("Where, as here, a contract provides both for the sale of goods and for the rendition of services, Illinois courts apply the 'predominant purpose' test in determining whether the contract falls within article 2 of the UCC."); Allied Shelving & Equip., Inc. v. Nat'l Deli, LLC, 154 So. 3d 482, 484 (Fla. Dist. Ct. App. 2015) ("In such instances, the determination whether the "predominant factor" in the contract is for goods or for services is a factual inquiry unless the court can determine that the contract is exclusively for goods or services as a matter of law."); Wall St. Network, Ltd. v. N.Y. Times Co., 80 Cal. Rptr. 3d 6, 19 (Ca. Ct. App. 2008).

[109] *Glossary of Insurance Terms*, NAIC, https://content.naic.org/consumer_glossary#I (last visited Mar. 14, 2022).

losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk."[110] These ideas of pooling are more useful than the standard statement about risk distribution, which has conceptual and implementation problems discussed later.[111]

In summary, in reviewing the major treatises on insurance, we should say that if there are any "commonly accepted notions of insurance" in the insurance field, the *Appleman* test might be it: (1) substantial control test, meaning an exposure to loss and the actual transfer of risk; (2) principal object or ancillary test, meaning the point of the contract is to obtain insurance, not something else that may include an insurance component; (3) regulatory value test, meaning there is a public interest in regulating this activity as insurance.[112]

Earlier insurance treatises are informative but no more definitive on a common notion of insurance. Joseph K. Angell, in *A Treatise on the Law of Fire and Life Insurance,* states:

> A more general definition is, a contract by which one of the parties binds himself to the other, to pay him a sum of money, or otherwise *indemnify* him, in the case of the happening of a fortuitous event provided for in a general or special manner in the contract, in consideration of the sum of money which the latter pays, or binds himself to pay him. It is a contract to protect men against uncertain events which *in any wise* may be a disadvantage to them.[113]

Robert Riegel and Jerome S. Miller in *Insurance Principles and Practices* state:

> Insurance is pre-eminently social in nature. It represents, in the highest degree, co-operation for mutual benefit. Various individuals who are all subject to similar risks combine to reduce the consequences of these risks, many thousands of persons paying premiums in order that the unfortunate few may be indemnified for the losses that

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[110] GEORGE E. REJDA & MICHAEL J. MACNAMARA, PRINCIPLES OF RISK MANAGEMENT AND INSURANCE 20 (Donna Battista et al. eds., 12th ed. 2014).

[111] *See infra* Part I and Part VII.

[112] 1 HOLMES, *supra* note 87, § 1.4.

[113] JOSEPH K. ANGELL, A TREATISE ON THE LAW OF FIRE AND LIFE INSURANCE 3 (Boston, Little, Brown & Co. 2d ed. 1855) (footnotes omitted).

> will occur. This principle of mutuality is present in a "stock company" organized for profit, as well as in a "mutual company," because in the last analysis losses are paid from premiums.[114]

Allen H. Willett, in *The Economics Theory of Risk and Insurance,* defines insurance "as that social device for making accumulations to meet uncertain losses of capital which is carried out through the transfer of the risks of many individuals to one person or to a group of persons."[115]

Robert I. Mehr and Emerson Cammack in *Principles of Insurance* state:

> Insurance itself may be defined as a social device for reducing risk by combining a sufficient number of exposure units to make their individual losses collectively predictable. The predictable loss is then shared proportionately by all those in the combination. This definition implies *both* that uncertainty is reduced and that losses are shared. These are the important essentials of insurance.
>
> From the point of view of the individual insured, insurance is a device that makes it possible for him to substitute a small, definite cost (the premium) for a large but uncertain loss (up to the amount of the insurance) under an arrangement whereby the fortunate many who escape loss will help to compensate the unfortunate few who suffer loss.[116]

Frank Joseph Angell in *Insurance Principles and Practices* states that insurance can be defined from a legal standpoint as a contract; from a social standpoint "as a method of combining a large enough group of units to make the loss predictable. . . . [T]o enable[] the individual to obtain insurance at a reasonable rate and thus to protect himself against the

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[114] ROBERT RIEGEL & JEROME S. MILLER, INSURANCE PRINCIPALS AND PRACTICES 23 (3d ed. 1947).

[115] ALLAN H. WILLETT, THE ECONOMIC THEORY OF RISK AND INSURANCE 72 (1951).

[116] ROBERT I. MEHR & EMERSON CAMMACK, PRINCIPLES OF INSURANCE 33–34 (3d ed. 1961).

possibility of disastrous losses;" and from an accounting standpoint "as a method of substituting a small certain loss for a large uncertain loss."[117]

Neil A. Doherty, a professor of insurance at the Wharton School, gave this definition in a case on captive insurance: "[a]n institution whereby a number of individuals or firms transfer their premiums and their exposures to loss to a common fund, and the common fund is then available to pay for the losses of whoever might suffer them."[118] The court further noted that Doherty stated that "the risk dimension that is being transferred is the unpredictability or variability of loss and not the expected loss or long run average cost.[119]

This leaves us with a variety of definitions of insurance, none of which can be said to be common notions. As with many things, the more we try to define something, the more difficult we find a definition to be, while more people seem to think they know it when they see it. If the insurance treatises and insurance cases struggle to define insurance, it should generate

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[117] FRANK JOSEPH ANGELL, INSURANCE PRINCIPLES AND PRACTICES 3 (1959) (italics omitted). These ideas of insurance as a social aspect were taken in a different direction, viewing "insurance companies as voluntary associations, alternative to the state, which provide social benefits." Carol Weisbrod, *Insurance and the Utopian Idea*, 6 CONN. INS. L.J. 381, 384 (2000). The author notes connections between religion and insurance, which we could more accurately restate as being the fraternal associations and reciprocal exchanges that later were classified as insurance:

> The idea of insurance as compensation for losses resulting from various ascertainable risks can be viewed as building on utopian security goals. The questions in their largest formulation involve the relation between freedom and security. In contract terms, the questions relate to the idea of solidarity and the nature of the commitments which individuals make to each other, whether a commitment is to a global framework or to a legal system which recognizes individual insurance contracts.
>
> The utopian idea has a clear connection to fraternal organizations as providers of insurance, as it does to the history of immigration and the attempts by social agencies to assist them. Both the insurance agent and the "friendly visitor" (as well, one assumes, as the parish priest) visited the homes of the poor.
>
> But it is also linked to the history of these independent insurance companies that stressed service goals.

Id. at 402–03 (footnotes omitted).

[118] Ocean Drilling & Expl. Co. v. United States, 24 Cl. Ct. 714, 727 (1991), *aff'd*, 988 F.2d 1135 (Fed. Cir. 1993).

[119] *Id.*

strong doubts that the tax cases can assume, adopt, or declare commonly accepted notions of insurance.

B. STATE INSURANCE STATUTES DEFINE INSURANCE, MORE OR LESS

State statutory definitions are generic statements of insurance. More importantly, the tax court cases that specify factors for commonly accepted notions of insurance are nowhere within those definitions. Here are a few such statutes:

California:

> "Insurance is a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event."[120]

Connecticut:

> (11) "Insurance" means any agreement to pay a sum of money, provide services or any other thing of value on the happening of a particular event or contingency or to provide indemnity for loss in respect to a specified subject by specified perils in return for a consideration. In any contract of insurance, an insured shall have an interest which is subject to a risk of loss through destruction or impairment of that interest, which risk is assumed by the insurer and such assumption shall be part of a general scheme to distribute losses among a large group of persons bearing similar risks in return for a ratable contribution or other consideration.
>
> (12) "Insurer" or "insurance company" includes any person or combination of persons doing any kind or form of insurance business other than a fraternal benefit society, and shall include a receiver of any insurer when the context reasonably permits.[121]

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[120] CAL. INS. CODE § 22 (Deering, LEXIS through 2022 Reg. Sess.).
[121] CONN. GEN. STAT. § 38a-1 (West, Westlaw through 2022 Reg. Sess.).

Massachusetts:

> "A contract of insurance is an agreement by which one party for a consideration promises to pay money or its equivalent, or to do an act valuable to the insured, upon the destruction, loss or injury of something in which the other party has an interest."[122]

New York:

> "Insurance contract" means any agreement or other transaction whereby one party, the "insurer", is obligated to confer benefit of pecuniary value upon another party, the "insured" or "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.[123]

A California case interpreting the California statute, and relying on cases from around the country to explain insurance, quoted this explanation:

> Whether the contract is one of insurance or of indemnity . . . there must be a risk of loss to which one party may be subjected by contingent or future events and an assumption of it by legally binding arrangement by another. Even the most loosely stated conceptions of insurance and indemnity require these elements. Hazard is essential and equally so a shifting of its incidence. If there is no risk, or there being one it is not shifted to another or others, there can be neither insurance nor indemnity. Insurance also, by the better view, involves distribution of the risk, but distribution without assumption hardly can be held to be insurance.[124]

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[122] MASS. GEN. LAWS ANN. ch. 175 § 2 (West, Westlaw through 2022 2nd Annual Sess.).

[123] N.Y. INS. LAW § 1101 (McKinney, Westlaw through 2022 Legis.).

[124] Cal. Physicians' Serv. v. Garrison, 172 P.2d 4, 12 (Cal. 1946) (quoting Jordan v. Grp. Health Ass'n, 107 F.2d 239, 245 (D.C. Cir. 1939)).

V. COMPARING INSURANCE NOTIONS AGAINST TAX NOTIONS OF INSURANCE

The tax court decisions that have spawned their own commonly accepted notions of insurance do not all square with the insurance practice and law's notions of insurance. These decisions and treatises are compiled in the table below.

Reserve Mechanical[125]	***Securitas Holdings***[126]
1. "[W]hether it was created for legitimate nontax reasons; 2. whether there was a circular flow of funds; 3. whether the entity faced actual and insurable risk; 4. whether the policies were arm's-length contracts; 5. whether the entity charged actuarially determined premiums; 6. whether comparable coverage was more expensive or even available; 7. whether it was subject to regulatory control and met minimum statutory requirements; 8. whether it was adequately capitalized; and 9. whether it paid claims from a separately maintained account."	1. "[T]he insurer was organized, operated, and regulated as an insurance company; 2. the insurer was adequately capitalized; 3. the insurance policies were valid and binding; 4. the premiums were reasonable; and 5. the premiums were paid and the losses were satisfied."

[125] Rsrv. Mech. Corp. v. Comm'r, 115 T.C.M. (CCH) 1475, 2018 T.C.M. (RIA) ¶ 2018-086, slip op. at 38–39 (2018), *appeal docketed*, No. 18-9011 (10th Cir. Dec. 27, 2018).

[126] Securitas Holdings, Inc. v. Comm'r, 108 T.C.M. (CCH) 490, 2014 T.C.M. (RIA) ¶ 2014-225, slip op. at 27 (2014).

New Appleman on Insurance Law[127]	***Appleman On Insurance Law & Practice***[128]
1. "What is the private interest sought to be protected in the commercial transaction? . . . 2. Who is the party assuming the risk transferred? Is the protected interest indigenous to that party? . . . 3. Is the protected interest indigenous to the state and all its citizens? . . . 4. Does the value of the indigenous interest invoke the purposes and policies of state insurance regulation for all its citizens?"	1. Substantial control; 2. Principal object and ancillary; and 3. Regulatory value

Some of the tax court questions are useful and relevant when examining instances that resemble insurance, and many are useful for examining the financial and economic substance of the transactions between the parent corporation and its subsidiary. However, that does not make them instances of proving insurance in practice. Certainly, the tax courts and the IRS should ask whether a captive insurer was formed for a legitimate non-tax purpose (this goes with the *Appleman* test of principal object and purpose),[129] and whether there was a circular flow of funds (as posited in *Reserve Mechanical* factor 2).[130] Certainly, the premiums should be actuarially based (as posited in *Reserve Mechanical* factor 5).[131]

Thereafter, the tax courts' view of commonly accepted notions fail as insurance notions. *Reserve Mechanical* factor 4 (for arms-length transactions)[132] will be problematic in assessing the independence of a subsidiary corporation. Until the twentieth century, a corporation could not

[127] Jerry, *supra* note 81, § 1.03[3][b][iv].
[128] 1 HOLMES, *supra* note 87, § 1.4.
[129] *See supra* notes 99–01, 128 and accompanying text.
[130] *See supra* note 125 and accompanying text.
[131] *Id.*
[132] *Id.*

even hold the shares of a subsidiary corporation unless the legislative grant of the corporate charter specifically allowed it.[133] There may, of course, be finance and control issues that undercut a legitimate business of the subsidiary, and which denigrate, if not collapse, the separate corporate legal entity of the subsidiary. Meanwhile, practical and economic realities of the relationship between a subsidiary and its parent will always evince the links of some corporate control, like members of the parent having some board seats on the subsidiary and the reality of consolidated financial statements. That does not deny the separate legal existence of a subsidiary,[134] nor make it contradict a notion of insurance. Further, if transactions within a corporate group are viewed as a whole, then every transaction would fail to survive the business purpose test.[135] Thus, some false notion of insurance cannot be the reason to disregard the transaction.

Reserve Mechanical factors 7, 8, and 9[136] seem inherent to insurance regulation: if a state regulator or off-shore domicile regulator says the company is an insurance company in good standing, then that should end the

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[133] *See* JAMES C. BONBRIGHT & GARDINER C. MEANS, THE HOLDING COMPANY: ITS PUBLIC SIGNIFICANCE AND ITS REGULATION 55–58 (New York, Augustus M. Kelly 1st ed. 1969). *See also* Kateena O'Gorman, *Remembering the Concept of the Corporation*, white paper presented at the Stanford/Yale Junior Faculty Forum, May 29, 2009, at 13–19; 6A WILLIAM MEADE FLETCHER ET AL., CYCLOPEDIA OF THE LAW OF CORPORATIONS §§ 2825-26 (Thomson Reuters ed., Westlaw, database updated Apr. 2022); William Randall Compton, *Early History of Stock Ownership by Corporations*, 9 GEO. WASH. L. REV. 125, 130–32 (1940); Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 575 n.2, 606–11 (1986); Note, *Power of a Corporation to Acquire Stock of Another Corporation*, 31 COLUM. L. REV. 281, 281–85, 288–89 (1931). Of note, Bonbright & Means contend that in 1888, New Jersey became the first state to allow a corporation to hold shares of a subsidiary corporation. BONBRIGHT & MEANS, *supra* note 133, at 55. However, Fred Freedland argues that New York was the first jurisdiction to grant the general right for one corporation to own share of another, in 1853, for life and health insurers, and thereafter for other insurers, banks and railroad corporations. Fred Freedland, *History of Holding Company Legislation in New York State: Some Doubts as to the "New Jersey First" Tradition,* 24 FORDHAM L. REV. 369, 370–77 (1955).

[134] *See* Bobby L. Dexter, *Rethinking "Insurance," Especially After AIG*, 87 DENV. U. L. REV. 59, 76 (2009).

[135] *See* Donald Arthur Winslow, *Tax Avoidance and the Definition of Insurance: The Continuing Examination of Captive Insurance Companies*, 40 CASE W. RSRV. L. REV. 79, 118 (1989).

[136] *See supra* note 125 and accompanying text.

tax inquiry on that point.[137] One author stated the point as: "insurance is what regulators allow insurers to do."[138] Unless there is a basis to call the captive insurance company a corporate sham or operating illegally[139]—which sometimes may be the case—there is little a court should do with *Reserve Mechanical* factors 7 and 8[140] as to deciding insurance. If the court does find a corporate sham, then the problem needs to be referred to the appropriate regulator.

Reserve Mechanical factor 9 (whether claims were funded from a separately maintained account)[141] was essentially rejected in a California insurance case. "Whether an entity is an insurer does not depend on the entity's size, sophistication, corporate retention policies, or claims handling abilities."[142] The court then looked at the California insurance statutes and the "principal object and purpose" test to determine whether the contract constituted insurance.[143]

Reserve Mechanical factor 6 (whether comparable coverage was more expensive or even available)[144] presents several problems. As to price, this has nothing to do with any notion or definition of insurance. Whether to pay more, or too much, is a purchaser's decision, not a seller's decision. There is no insurance law that requires a buyer to avoid expensive insurance. There may actually be some legitimate reasons to pay more for insurance, such as (1) the expensive insurer provides a package of coverages and policies that might be too hard to put together from several insurers and might create gaps in coverage; (2) risk control services might be provided

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[137] *See, e.g.*, *In re* Stewart's Shops Corp., DTA No. 825745, 2016 WL 1086062 (N.Y. Div. Tax. App. Mar. 10, 2016) (New York-licensed captive); Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835 (6th Cir. 1995) (Colorado-licensed captive); Kiddie Indus., Inc. v. United States, 40 Fed. Cl. 42, 51 (Fed. Cl. 1997), *dismissed*, 194 F.3d 1330 (Fed. Cir. 1999) (Bermuda-licensed captive); R.V.I. Guar. Co. & Subsidiaries v. Comm'r, 145 T.C. 209 (2015) (Connecticut-licensed captive).

[138] Christian Thimann, *What is Insurance and How Does it Differ from General Finance?*, *in* THE ECONOMICS, REGULATION, AND SYSTEMIC RISK OF INSURANCE MARKETS 5, 13 (Felix Hufeld, Ralph S. J. Koijen, & Christian Thimann eds., 2017).

[139] *See, e.g.*, Ocean Drilling & Expl. Co. v. United States, 24 Cl. Ct. 714, 728–29 (1991), *aff'd*, 988 F.2d 1135 (Fed. Cir. 1993) (analyzing if the corporation was a sham).

[140] *See supra* note 125 and accompanying text.

[141] *Id.*

[142] Truck Ins. Exch. v. Amoco Corp., 41 Cal. Rptr. 2d 551, 556 (Cal. Ct. App. 1995).

[143] *Id.* (reviewing CAL. INS. CODE §§ 22–23 (Deering, LEXIS through 2022 Reg. Sess.)).

[144] *See supra* note 125 and accompanying text.

and thus justify a higher price; and (3) a hardening market may motivate the decision to remain with a long-standing carrier rather than switch. If, in fact, the price for the insurance is far out of line with what is commercially available, then this goes to a management failure for waste of corporate assets, for which the remedy is a shareholder action (even a private corporation may use this remedy) or a state attorney general investigation.[145]

As to the availability of coverage under *Reserve Mechanical* factor 6,[146] this too does not define insurance. The insurance industry has multiple ways to provide unique coverages, mostly through the surplus lines markets, which specialize in providing one-off coverages.

> Surplus lines insurance is property and casualty coverage that is underwritten by a non-admitted insurer for nonstandard risks or policy levels that are unavailable in the commercial market. Policies may not be issued through the surplus lines market without a licensed surplus lines broker pursuing the coverage in the admitted market, without success.[147]

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[145] *See* 16A FLETCHER ET AL., *supra* note 133, § 8068.10; N.Y. BUS. CORP. LAW § 720 (McKinney, Westlaw through 2022 Legis.); Michelson v. Duncan, 407 A.2d 211, 217 (Del. 1979) ("The essence of a claim of waste of corporate assets is the diversion of corporate assets for improper or unnecessary purposes.");

> [W]e have defined "waste" to mean "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." As a practical matter, a stockholder plaintiff must generally show that the board "irrationally squander[ed]" corporate assets—for example, where the challenged transaction served no corporate purpose or where the corporation received no consideration at all.
>
> Under this standard, a corporate waste claim must fail if "there is *any substantial* consideration received by the corporation, and . . . there is a *good faith judgment* that in the circumstances the transaction is worthwhile."

White v. Panic, 783 A.2d 543, 554 (Del. 2001) (citations omitted).

[146] *See supra* note 125 and accompanying text.

[147] Julie Mix McPeak, *Regulation of Non-Admitted Market/Surplus Lines, in* 2 NEW APPLEMAN ON INSURANCE LAW § 9.09[1] (Jeffrey E. Thomas & Martin F. Grace eds., Library ed., LEXIS, database updated May 2022).

This is the reason for, and often the realm of, surplus lines insurers, to develop and underwrite insurance for unusual or evolving risks.

> Surplus lines insurers mainly focus on the development of new coverages and the structuring of policies and premiums appropriate for risks. New and innovative insurance products for which there is no loss history are difficult, if not impossible, to appropriately price using common actuarial methods. Often, after a new coverage has generated sufficient data, the coverage eventually becomes a standard product in the admitted market.[148]

How much effort does an insured, its broker, and the surplus lines broker, put into such a search for comparable coverages and prices to decide whether a captive is an appropriate alternative? Whatever the answer, there is almost always a surplus lines insurer that can underwrite the risk (after appropriate compliance with the surplus lines brokerage requirements).[149] The best known of the surplus insurers is the Lloyds of London syndicates, which essentially will cover anything.[150] This means that the question of whether an insurer would be willing to write a unique coverage is a flawed basis for determining whether a captive is insurance in the commonly

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[148] *Surplus Lines*, NAT'L ASS'N OF INS. COMM'RS: CTR. FOR INS. POL'Y & RSCH. https://content.naic.org/cipr_topics/topic_surplus_lines.htm (Oct. 14, 2021). "As of year-end 2018, surplus lines direct premium volume was $49.9 billion representing 7.4% of the $676.6 billion of total U.S. direct premiums written. Although the surplus lines premium seems minimal compared to the total, in the absence of this market, many insureds would be unable to secure coverage." *Id*.

[149] *See, e.g.*, CAL. INS. CODE § 1763 (Deering, LEXIS through 2022 Reg. Sess.); N.Y. INS. LAW § 2118 (McKinney, Westlaw through 2022 Legis.); 15 U.S.C.A. § 8204; NAT'L ASS'N OF INS. COMM'RS, NONADMITTED INSURANCE MODEL ACT (2002), https://content.naic.org/sites/default/files/inline-files/MDL-870.pdf. *See generally* McPeak, *supra* note 147 ("State insurance departments regulate surplus lines insurers through eligibility determinations to participate in the surplus lines market within the state. However, surplus lines brokers are extensively regulated by state insurance departments through initial licensure, due diligence searches, reporting obligations and remittance of taxes. The insurance commissioner requires a surplus lines agent to determine the scope and availability of coverage in the admitted market and the eligibility of the surplus lines insurer prior to placing the insurance coverage.").

[150] *See generally What Lloyd's Insures*, LLYOD'S, https://www.lloyds.com/about-lloyds/what-we-insure (last visited Apr. 22, 2022).

accepted sense. Unless a state insurance statute or regulation says that insurance is illegal, it is probably available.

Indeed, pushing this question only a little further raises serious questions about the element of risk distribution, which is usually (but not always) based on a large number of homogenous units. The advantage of having a large number of homogenous units is that it allows for probability determinations of losses, and thus prices for those similar exposures.[151] That is the case for standard lines of insurance and sometimes for surplus lines of insurance, such as windstorm and even private flood risks, where the peril or exposure is common—but the admitted insurers decline to insure against catastrophic losses. That is sometimes *not* the case for surplus lines of insurance, such as insuring satellite launches,[152] the first offshore wind farms, cryogenic human storage, pollution sites, and computer networks in

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[151] *See* Neil A. Doherty, *The Design of Insurance Contracts When Liability Rules are Unstable*, 58 J. RISK & INS. 227, 229 (1991) ("From the law of large numbers it is known that an insurance market with a large number of independent exposures will substantially reduce portfolio risk."). *See also* ANGELL, *supra* note 117, at 19 ("The law of large numbers may be defined as follows: The greater the number of exposure units, the nearer the actual results will approach the underlying probability." (italics omitted)); 1 JEFFREY W. STEMPLE & ERIK S. KNUTSEN, STEMPEL AND KNUTSEN ON INSURANCE COVERAGE § 1.03[A] (4th ed. 2020); REJDA & MCNAMARA, *supra* note 110, at 20–21.

[152] Piotr Manikowski & Mary A. Weiss, *The Satellite Insurance Market and Underwriting Cycles*, 38 GENEVA RISK & INS. REV. 148, 170 (2013) ("Recall that this line does not benefit from the law of large numbers relative to most other insurance lines with respect to homogeneity of data. Hence data for several periods as well as considerable judgment may enter the rating process leading to a longer cycle period."). The articles notes that the first insurance policy on a satellite was in 1965, and that (as of 2013) there are usually no more than thirty launches a year though losses can exceed $250 million, thus several insurers will subscribe to one launch. *Id.* at 152–54. As to setting the premium, "rates have been set in reaction to claims experience (recent market experience), rather than by statistical analysis of the launch and in-orbit record." *Id.* at 158 (citation omitted). This indicates insufficient data to predict probabilities, or at least insufficient use of and credibility of the limited data. The point is also made in Neil A. Doherty, *Risk-Bearing Contracts for Space Enterprises*, 56 J. RISK & INS. 397, 401 (1989) ("First, satellite insurance pools are small. . . . In recent years, the number of insured launches per year was 20 or less. Moreover, these were not all covered by all underwriters. Thus, each underwriter has carried only a handful of coverages in any year. This is an insufficient base from which to diversify risk effectively.") But the lack of diversification due to few insured exposures in satellite launches is diversified by the insurer's portfolio of aviation risks. *Id.*

cyber insurance.[153] Even contests with payouts, such as to capture the Loch Ness Monster for a £1,000,000 prize[154] or a hole-in-one in golf are insured.[155]

Some of these were one-of-a-kind or rare exposures, until they became common enough to price with some experience, and more common later to move into the standard lines where they meet a tax court's idea of what is common notions of insurance. Surplus lines insurers regularly take

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[153] A specialty brokerage in Atlanta, INSUREtrust, created the first cyber policy in 1997. Andrea Wells, *What Agent Wrote First Cyber Policy Thinks About Cyber Insurance Now,* INS. J. (Mar. 1, 2018), https://www.insurancejournal.com/news/national/2018/03/01/481886.htm; Brian D. Brown, *The Ever-Evolving Nature of Cyber Insurance,* INS. J. (Sept. 22, 2014), https://www.insurancejournal.com/magazines/mag-features/2014/09/22/340633.htm. *See also INSUREtrust: Cyber Insurance & Risk Management Leader*, ENTER. SEC., https://risk-and-compliance-management.enterprisesecuritymag.com/vendors/insuretrust/2021 (last visited Apr. 23, 2022).

[154] ANTONY BROWN, LLOYD'S OF LONDON 154 (1974). The premium was £2,500, the policy period was one year from May 1, 1971, and provided the following coverage, written in all capital letters:

> THIS POLICY IS TO PAY £1,000,000 IN THE EVENT OF THE LOCH NESS MONSTER BEING CAPTURED ALIVE (UNDER THE RULES OF A COMPETITION RUN BY CUTTY SARK) IN LOCH NESS BETWEEN 1ST MAY, 1971, AND 30TH APRIL, 1972. AS FAR AS THIS INSURANCE IS CONCERNED THE LOCH NESS MONSTER SHALL BE DEEMD TO BE: -
> 1) IN EXCESS OF 20 FEET IN LENGTH
> 2) ACCEPTABLE AS THE LOCH NES MONSTER TO THE CURATORS OF THE NATURAL HISTORY MUSEUM, LONDON,
>
> IN THE EVENT OF LOSS HEREUNDER: -
> A) THE MONSTER SHALL BECOME THE PROPERTY OF UNDERWRITERS HEREON.
> B) IMMEDIATE NOTICE TO BE GIVEN TO UNDERWRITERS HEREON.

Photograph of Lloyd's Loch Ness Monster Insurance Policy, *in* ANTONY BROWN, LLOYD'S OF LONDON (1974), following p. 146.

[155] Hole-in-one insurance for golf tournaments would not seem to fit anyone's idea of a commonly accepted notion of insurance, but it is insurance. *See, e.g.*, Golf Mktg. Worldwide, LLC v. State Ins. Dep't, No. CV020523382S, 2004 Conn. Super. LEXIS 926 (Conn. Super. Ct. 2004) (finding that paying a contract price to cover the risk of paying out cash or a new automobile as prizes for scoring a hole in one constitutes insurance).

one-off types of risks with little historical data for pricing.[156] That does not in any way reduce the risk transfer from insured to insurer, nor contrary to the tax court decisions that contend a captive insurer for a one-off risk. It does make the prediction of loss more of a gamble. But the unpredictable losses on the small line of insured risks (such as satellites) are diversified by the insurer's overall portfolio, creating cross-pooling. "Thus the satellite risks can be, and are, pooled with all other business. This 'cross line pooling' can dramatically reduce the overall risk to the firm if the cross line correlations are low."[157] That is risk transfer, and that is the object and purpose of the transaction; thus fully qualifying the event as insurance.

The insurance market also provides political risk coverage, tax liability insurance, transaction representation and warranty insurance, credit receivables insurance, event cancellation insurance, film completion insurance, and specialized insurance on athletes (a type of disability insurance)–to name a few. Outside of the insurance and risk industries, few people would think of these as insurance. Yet, within the insurance and risk industries, these are known among the specialists who deal with these exposures.

Beyond surplus lines, the insurance industry goes even further with "alternative risk transfer" to deal with the most unique exposures.[158] This is insurance, too.

In sum, the tax courts' view of factors constituting "commonly accepted notions of insurance" mostly does not align with the insurance industry's views of notions of insurance. Actually, some of those factors do not even deal with insurance; they deal more with corporate law and corporate governance. As one author stated at the start of the captive-tax collision in 1990: "problems present in the captive context are best dealt with by other solutions, and not by manipulating the definition of insurance."[159] The author observed that "tax authorities, purporting to base their decisions

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[156] *See* Shawn Moynihan, '*Specialty" Treatment': The State of the E&S Market.* PROP. CAS. 360 (Sept. 08, 2017, 2:30 AM), https://www.propertycasualty 360.com/2017/09/08/specialty-treatment-the-state-of-the-es-market/.

[157] Doherty, *supra* note 152, at 401.

[158] *See, e.g.*, Jens Peters, *What is Alternative Risk Transfer?*, WILLIS TOWERS WATSON (Aug. 17, 2017), https://www.willistowerswatson.com/en-US/insights/2017/08/what-is-alternative-risk-transfer; ALLIANZ GLOBAL CORPORATE & SPECIALTY SE, SALES APPETITE: ALTERNATIVE RISK TRANSFER AT A GLANCE (2021), https://www.agcs.allianz.com/content/dam/onemarketing/agcs/agcs/countries/agcs-usa/marketing-brochures/AGCS-North-America-Alternative-Risk-Transfer-At-A-Glance.pdf.

[159] Winslow, *supra* note 135, at 84.

on a definition of insurance, may be influenced by factors other than pure insurance theory or economics."[160]

To tell the courts there is no definition or common notion of insurance can correct the tax courts' errors, but it does not provide help to decide if a captive is insurance. Also, there are insurance commissioners and staff who deal with insurance questions every day, and insurers around the world who write trillions of dollars of risk every year. Surely something more can be said as to what is insurance other than: *if it is regulated as insurance then it is insurance*. The *Appleman* test seems the sturdiest of the possible ways to determine what is insurance.[161] Can we build on that? Recognizing the difficulty and possible futility of trying to define insurance beyond risk distribution and risk pooling, perhaps the following provisional definition, informed by the struggles of prior authors, might be considered:

> Insurance is an agreement to provide financial protection against specified categories of future fortuitous losses, by an entity licensed to transact insurance and in the business of insurance, for a specified time, and a specified premium calculable based on anticipated probabilities of individual and aggregate losses that the insurer can likely bear, and on such other terms and conditions agreed upon, and consistent with any regulatory constraints on its operations. The principal object and purpose of this insurance must be solely the transfer of the risk of specified categories of future fortuitous losses, and not be ancillary within any other contract between two parties for the principal purpose of providing goods or services.

This does not solve all the definitional problems or exceptions that can be thought of that perforate even this definition. But this tentative definition, or the *Appleman* test,[162] may work adequately to get a broad enough description that would embrace much of what the insurance domain thinks of as insurance, and thus guide the tax courts in deciding whether particular captive tax cases constitute insurance, even if other factors of the captive relationship are disturbing.

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[160] *Id.* at 92.
[161] *See supra* note 128.
[162] *Id.*

VI. THE VARIETY OF INSURANCE COMPANIES MAKES FOR UNCOMMON NOTIONS OF INSURANCE

Another factor that affects the tax court decisions of what is insurance, is the idea that insurance must be entirely transferred to another entity. That is largely true. Except the variety of insurance companies means that some risk may be retained by the policyholder itself, beyond the usual deductibles and self-insured retentions. Most insurance companies are stock companies (owned by shareholders) and mutual companies (owned by the policyholders), also called proprietary and cooperative insurers.[163] Similar to a mutual insurer is a reciprocal or interinsurance exchange.[164] These mutuals and their subspecies are important to demonstrate risk distribution among the policyholder-members and to demonstrate that true risk distribution among policyholder-members also involves an element of partial risk retention. As *Couch* explains about these types of insurers:

> A reciprocal or interinsurance exchange is an aggregation of persons, called subscribers, who, through an attorney-in-fact, cooperate to furnish themselves and each other insurance against a designated risk, and the subscribers are both the insured and the insurers. The reciprocal plan is designed for those who desire to assume the positions of both the insurer and the insured for the purpose of eliminating that part of the ordinary insurance premium that goes into profit. Another economy in reciprocal insurance from the standpoint of the subscriber lies in the fact that he or she insures himself or herself at an actual cost without the use of an expensive agency system and also in the lower-loss ratio attributable to the care used in the selection of subscribers.
>
> . . . Again, mutual companies often are incorporated, whereas reciprocal associations or exchanges have no corporate existence, although the attorney-in-fact often does become incorporated.
>
> A reciprocal exchange differs from both stock and mutual insurance companies. It has no stock and no capital as such. The contingent liability of the subscribers to make

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[163] 3 PLITT, MALDONADO, ROGERS & PLITT, *supra* note 78, § 39:1.
[164] *See id.*

> payments in addition to their premiums stands in the place of the capital of a stock company. The liability of a subscriber is in some respects similar to a liability upon an unpaid subscription to the stock of a corporation.
>
> It appears that a reciprocal or interinsurance exchange is something more than a partnership and something less than an insurance corporation.[165]

Note here the absence of a separate insurance company unrelated to the policyholder, and sometimes even the absence of a separate corporation bearing the insurance (though these associations can be separate legal entities). The reciprocal is more like a partnership, as quoted above, and as Doherty and Dionne explain.[166] This nevertheless is insurance, and is regulated as insurance, because there is risk shifting despite the fact that some risk remains with the insured. Reciprocals were an old form of insurance, before insurance regulation, as explained by a Minnesota court in 1929:

> It is a well-known fact that reciprocal or interinsurance exchanges existed in this country prior to enactment of laws authorizing them. Certain groups of individuals had found this plan an economical and practical method of providing indemnity. One man might not be sufficiently strong financially to bear the risk of loss alone, but he and a number of his friends and acquaintances or others engaged in the same line of business could form a group or association abundantly able to act as their own insurers, and thus procure insurance at or near its actual cost.[167]

Relevant to the current captive insurance taxation question, premiums paid to a reciprocal (for flood insurance) are tax deductible.[168] Thus, risk distribution can exist even when the insured retains a portion of the risk and is exposed to the risk of everyone else. The implication on the

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[165] *Id.* § 39:48 (citations omitted).

[166] Neil A. Doherty & Georges Dionne, *Insurance with Undiversifiable Risk: Contract Structure and Organizational Form of Insurance Firms*, 6 J. RISK & UNCERTAINTY 187 (1993).

[167] *In re* Minn. Ins. Underwriters, 36 F.2d 371, 372 (D. Minn. 1929).

[168] United States v. Weber Paper Co., 320 F.2d 199, 204–05 (8th Cir. 1963).

captive insurance cases is that total and absolute transfer of the risk (except the deductible) is not a criteria for defining insurance.

Doherty and Dionne, cited in *Ocean Drilling*,[169] provided a definition in that case and also in a prior article where they tried to define insurance. They explained that insurance is often provided by the policyholders themselves in mutual-type companies and pooling arrangements.[170] "[T]here has been a proliferation of new firms such as mutuals, reciprocals, group captive insurance companies, and risk retention groups. The essential feature of all of these organizational forms is that they are owned by their policyholders."[171] This pooling was evident in pollution insurance and earthquake insurance, they wrote.[172] "These organizational structures share the common feature of combining the equityholder and policyholder functions, thereby allocating residual claims on the insurance pool to the policyholders. Risk is pooled amongst those who are commonly exposed rather than transferred to external risk bearers."[173]

A similar consequence is claims-made liability insurance policies that leave the policyholder "exposed to much of the risk of changing liability rules. This is similar in effect to mutualization."[174] The point here is that risk

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[169] Ocean Drilling & Expl. Co. v. United States, 24 Cl. Ct. 714, 727 (1991), *aff'd*, 988 F.2d 1135 (Fed. Cir. 1993).

[170] Doherty & Dionne, *supra* note 166, at 187–88.

[171] *Id.* at 187.

[172] *Id.* at 187–88.

[173] *Id.* at 187–88. *See also* WILLET, *supra* note 115, at 79–80:

> A member of such a company is not in the same economic situation as one insured for a fixed premium. He has not transferred his risk and purchased security; he has exchanged one risk for another, usually a small chance of a large loss for a larger chance of a smaller loss. Where there is a mere diffusion of loss there remains some degree of uncertainty as to the amount of loss that each member of the group will suffer; where there is complete insurance the insurer has taken upon himself the entire chance of loss, so far as concerns the risks covered by the insurance.

[174] Doherty & Dionne, *supra* note 166, at 188. *See also* Doherty, *supra* note 152, at 228:

> These changes in contract or organizational design have a similar effect. The premium for any given period of cover is random. It is subject to retroactive adjustment on the basis of new information concerning the aggregate loss in the pool. For

transfer can still be in place even when the insurer includes the policyholder as equity holder. Rob Thoyts in *Insurance Theory and Practice* makes a similar point:

> The superficial answer would be that they are transferred to an insurer. The problem with this argument is that recognisable insurance transactions were taking place thousands of years before the first insurance companies appeared. In fact, the risk is being transferred from a number of individuals to a collective pool. This pool contains the collective risk of its members, together with the collective resources these members have set aside to meet the occurrence of such risk. Each member surrenders a small sum to the pool with the intention that this be used to meet the collective loss, regardless of where the loss actually falls.[175]

VII. RISK DISTRIBUTION IS SOMETIMES NOT WIDELY DISTRIBUTED

Risk distribution is not always so clear. One instance is the unique exposures that surplus lines insurers take on. Unlike the standard lines of insurance using the standard measures of pricing and distributing risk through a large number of homogenous exposure units, the surplus lines insurers may not have many homogenous exposure units because, by the nature of risks insured by surplus lines insurers, the risks are unique or unconventional. Nevertheless, these unique risks, while heterogenous, are distributed because they are uncorrelated exposures.

Another instance is small insurers, such as state farm bureau companies, which have concentrated risks, even if they have a decent number of homogenous exposure units. "These mutuals are small, local insurance operations which offer fire insurance primarily on farm property. . . . Some of them operate on an assessment basis which involves a small

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> example, the mutual may pay a dividend (positive or negative) to its policyholders which is related to the aggregate loss in the pool. The policy holder buying a claims made policy will find that losses which may have arisen, but which have not been presented as claims, within the policy year will be priced in the future in a future insurance contract.

[175] ROB THOYTS, INSURANCE THEORY AND PRACTICE 10–11 (2010).

initial premium but requires the policyholder to pay additional premiums if losses and expenses are greater than anticipated."[176] Distribution cannot be achieved solely within a smaller insurer, because of its narrow geographical range or concentrated lines of insurance or few numbers of insured, yet the insurer is still an insurer and provides important financial protection bearing the risk of its insureds. An example is the Merced Property & Casualty Co. of Atwater, started by farmers in 1906 for fire insurance for a small region of the California Central Valley. [177] After writing 100 insurance policies, it then expanded throughout the region.[178] Then in 2013, being acquired by another insurer, it went insolvent after the Camp Fire wildfire.[179] There were similar exposure units, risk distribution, risk pooling, and yet in a wildfire everything burns, bankrupting the insurer. As a California Court stated, "[w]hether an entity is an insurer does not depend on the entity's size, sophistication, corporate retention policies, or claims handling abilities."[180]

If the idea is that the risk of *this insured* suffering a risk of loss to *this insured's own* property, or liability for *this insured's own* acts, is transferred to another legal entity (minus any retained deductible), then there is no disagreement between the tax courts and insurance law and practice as to risk retention and risk transfer. The real point then of distribution is *pooling,* meaning "the spreading of losses incurred by the few over the entire group, so that in the process, average loss is substituted for actual loss."[181]

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[176] JAMES L. ATHEARN, RISK AND INSURANCE 385 (1962). *See also* 3 PLITT, MALDONADO, ROGERS & PLITT, *supra* note 78, § 39:17 ("Most of the farm mutuals operate on the unlimited assessment plan, but others may state a definite dollar limitation on the assessment or limit it to a certain multiple of the policyholder's premium."); Annotation, *Liability of Policyholders in Mutual Insurance Companies to Assessments*, 137 A.L.R. 945 (1942). A limited review of the state statutes shows how small these can be. *See, e.g.*, GA CODE ANN. § 33-16-3 (LEXIS through 2021 Reg. Sess.) (only twenty people are needed to start a farm bureau mutual); MINN. STAT. ANN. § 67A.01 (West, Westlaw through 2022 Reg. Sess.) (requiring twenty-five people); TEX. INS. CODE ANN. § 911.053 (West, Westlaw through 2021 Reg. Sess.) (requiring 100 people); COLO. REV. STAT. § 10-12-101 (LEXIS through 2021 Reg. Sess.) (requiring 100 people for a mutual insurance company of any kind).

[177] Dale Kasler & Michael Finch II, *Insurer Goes Bust from Camp Fire with Millions in Claims Unpaid. How Will it Affect Paradise Homeowners?,* SACRAMENTO BEE (Dec. 3, 2018, 12:00 PM), https://www.sacbee.com/news/california/fires/article222563185.html.

[178] *Id.*

[179] *Id.*

[180] Truck Ins. Exch. v. Amoco Corp. 41 Cal. Rptr. 2d 551, 556 (Cal. Ct. App. 1995).

[181] REJDA & MCNAMARA, *supra* note 110, at 20.

"[B]y pooling, or combining the loss experience of a large number of exposure units, an insurer may be able to predict future losses with greater accuracy."[182]

Insurers, big and small, solve the problem of inadequate risk distribution by buying reinsurance. The total premiums spent on reinsurance in 2019 were $61.8 billion dollars for the top twenty-five reinsurers:[183] "Basically, reinsurance is a mechanism for spreading risk."[184] Distribution is therefore achieved vertically, through reinsurance.[185] "[W]here an insurer is unwilling to assume at its own risk the whole of the insurance offered, it nevertheless does so, and reinsures so much of it in such form as it deems suitable and necessary to reduce its own ultimate exposure to loss to proper limits."[186] Insurers need the operational capacity of reinsurers "to sustain and survive catastrophic losses, the capacity to achieve statistically predictable loss behaviour, the capacity to carry costs of acquiring larger and larger amounts of new insurance . . . ."[187] In this way, the "gross underwriting capacity of the reinsurer may be said to have added to that of the ceding [primary] insurer . . . . The underwriting capacity of the reinsurer becomes the channel through which more even distribution of risk is achieved for the insurer."[188]

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[182] *Id.* at 21. *See also* FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 232–35 (1921). This goes back to the spread of risk, and the law of large numbers to forecast expected losses and thus to price the risk. Knight's point is expanded upon in George L. Head, *An Alternative to Defining Risk as Uncertainty*, 34 J. RISK & INS. 205 (1967). The debate about the meaning of risk is as broad as the debate about the meaning of insurance, and depends on the discipline doing the defining and the context.

[183] REINSURANCE ASS'N OF AM., REINSURANCE UNDERWRITING REVIEW: A FINANCIAL REVIEW OF U.S. REINSURERS 2019 INDUSTRY RESULTS 1 (2020), https://www.reinsurance.org/RAA/Industry_Data_Center/Reinsurance_Underwriting_Review/Reinsurance_Underwriting_Review.html.

[184] STEVEN C. SCHWARTZ, REINSURANCE LAW: AN ANALYTIC APPROACH § 2.02 (2018).

[185] *See* 1 STARING & HANSELL, *supra* note 20, § 1:3; Henry T. Kramer, *The Nature of Reinsurance*, *in* REINSURANCE 1, 6 (Robert W. Strain ed., 1980).

[186] Kramer, *supra* note 185, at 6. *See also* Thimann, *supra* note 138, at 6 ("The managing of risk takes place through pooling or mutualization— that is, the aggregation of a large number of similar risks, . . . or it takes place through cession [to reinsurers] and diversification . . . .").

[187] Kramer, *supra* note 185, at 3.

[188] *Id.* at 28.

> The control of an insurer's severity of loss by reinsurance is less a matter of theory or convenience than a necessity. . . . As a practical marketing matter, most insurers are obliged to accept sums insured which exceed the net retained limits within which the law of large numbers will work, at least over periods as short as one year or less. Viewed this way, reinsurance is a commercial activity that permits an insurer to do what it wants: to issue policies in the amounts required by its insureds.[189]

It has been stated that "'captive' insurance companies provide a testimonial to the necessity of reinsurance and its ability to provide capacity."[190] As the author explained in 1980, "without the availability of reinsurance one of the most interesting developments in the insurance business [captives] in the last twenty years would never have occurred."[191] The older *Appleman* treatise explained the importance of reinsurance to self-insured entities, which would include captives:

> Reinsurance is important to a self insurance program for a number of reasons. These reasons are quite similar to the functions played by reinsurance in the broader insurance market. First, it enables the program to establish a ceiling on the risks it will retain. Second, it enables the program to write risks it would otherwise deem unattractive, because of the ability of the program to share the risk through reinsurance. Third, it enables the program to obtain larger limits than if the program utilized solely its own internal capital and premiums. Finally, it enables the capital of the program to be used to write larger risks.[192]

Thus, the notion of risk distribution must be adjusted to the reality that insurers often do not achieve sufficient distribution in their portfolio,

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[189] *Id.* at 29. *See also* SCHWARTZ, *supra* note 184, § 2.02[3] ("By laying off part of the risk to its reinsurers, a company can write a policy that, without reinsurance, would have been beyond its underwriting capacity. Similarly, reinsurance may enable a company to write a greater number of policies, with a larger aggregate exposure, than it could without reinsurance.").

[190] Robert A. Baker, *The Purpose of Reinsurance*, *in* REINSURANCE 33, 34 (Robert W. Strain ed., 1980).

[191] *Id.*

[192] 14 HOLMES, *supra* note 87, § 102.7.

either because of an insufficient number of exposure units or limited geographical dispersion that subjects the units to the possibility of a common peril. To achieve practical, prudent, and profitable distribution, insurers, therefore, use reinsurance.

Sometimes risk is not entirely shifted away from the insured at all because the insurance is more of a mutual aid or pooling arrangement (disregarding deductibles and self-insured retentions). This is particularly so with risk retention groups, "whose primary activity consists of assuming and spreading all, or any portion, of the liability exposure of its group members," as authorized under the Federal Liability Risk Retention Act of 1986,[193] and which are "chartered or licensed as a liability insurance company under the laws of a State and authorized to engage in the business of insurance under the laws of such State . . . ."[194] Such risk retention groups are owned by the members.[195]

Further examination can be made of the fraternal organizations[196] and assessment mutual companies[197] to the same result. Insureds buy

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[193] Risk Retention Act of 1986, 15 U.S.C. § 3901(a)(4)(A).

[194] § 3901(a)(4)(C)(i). For statutory examples, see N.Y. INS. LAW § 5902 (McKinney, Westlaw through 2022 Legis.); CONN. GEN. STAT. § 38a-250 (West, Westlaw through 2022 Reg. Sess.).

[195] § 3901(a)(4)(E).

[196] *See, e.g.*, Nicholas F. Potter, *Fraternal Benefits Societies, in* 4 NEW APPLEMAN NEW YORK INSURANCE LAW § 51.05 (Wolcott B. Dunham & Aviva Abramovsky eds., 2d. ed., LEXIS, database updated Nov. 2021):

> Fraternal benefit societies are unique in their corporate structure, purposes and functions. They were primarily organized by groups of immigrants and their descendants. Their purpose was to provide a vehicle through which persons of common ethnic, national, or religious backgrounds, and workers in a common hazardous occupation or craft, could join together in local lodges to promote and retain their heritage and customs while at the same time provide a modicum of insurance protection for their members and families.

[197] *See, e.g.*, Md. Motor Truck Ass'n Workers' Comp. Self-Ins. Grp. v. Prop. & Cas. Ins. Guar. Corp., 871 A.2d 590, 598 (Md. 2005):

> The mere fact that the members retain joint and several liability for any remaining obligations of the Group does not suffice to preclude the Agreement from constituting an insurance contract. Section 504 of the Agreement also provides for the

insurance to transfer substantial risk, but they retain the risk of deficiencies if the insurer has insufficient surplus to pay for the losses, thus retaining some risk beyond their own deductibles. Despite this incomplete risk transfer, fraternal organizations and assessment mutual companies constitute insurance for state insurance purposes.[198]

Winslow, reviewing the insurance economics literature, contends that distribution can be difficult to define and may not even be necessary.[199] Further, an insured with a large number of exposure units—let's say a retail store with hundreds or thousands of locations, or a firm with a fleet of vehicles—may have enough frequency of losses that the uncertainty of loss becomes fairly certain. Once that happens, the purpose of insurance (to insure against uncertainty) disappears, thus defeating a captive insurance arrangement on the very grounds by which it is supposed to exist, by insuring a large number of exposure units.[200] We need not debate or resolve that here.

All these examples show that insurance exists perfectly well even when the insured shares in the risk of others and does not absolutely transfer the entire risk to another risk-bearing entity as a modern (but not necessarily traditional) insurer. Courts and insurance regulators have neither rejected risk groups nor small assessment mutuals on the grounds of tax courts' notions of insurance and inadequate distribution of risk. It might be more accurate to say that the traditional insurer was an association of insureds, and later an association of insurers in a reciprocal exchange of reinsurance, resulting in a better "spread of risk."[201]

CONCLUSION

Defining insurance beyond the core is hard even within the insurance domain. Insurance involves risk shifting and indemnity, and more than that, because that can be done in any contract between parties as ancillary to a

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> distribution of surplus funds, not needed for the payment of claims and administrative expenses or for a prudent cushion, to the members in the form of dividends. Such an arrangement—joint and several liability for a deficiency and the right to recover part of the surplus funds in the form of dividends—is a traditional characteristic of assessment mutual insurance companies.

[198] *See supra* notes 196–97.

[199] Winslow, *supra* note 135, at 150–58.

[200] *Id.* at 160–61. *See also* WILLET, *supra* note 115, at 4-8 (discussing the distinction between probability and uncertainty when defining risk).

[201] Kramer, *supra* note 185, at 2.

contract for goods and services. Risk transfer must be the primary goal of the contract. That involves risk distribution, which is often horizontal distribution among similar units, and sometimes among non-similar units if they are not correlated, as is done with unique risks in the surplus lines market. It is also done with vertical distribution through reinsurance where the insurer is too small to absorb a large individual loss or a large aggregate loss. The *Appleman* test of looking at the object and purpose of the transaction[202] is probably the best characterization of insurance, and the insurance definition offered within this article might also serve to embody the insurance industry's and insurance regulator's practice and consensus of what is insurance.

The tax courts' factors for determining insurance "in the commonly accepted sense" are mostly irrelevant to determining insurance, though they are important to trying to understand whether there are tax games afoot that try to hide behind insurance. The "resolution [whether a captive insurance arrangement is proper for tax purposes] lies not with the definition of insurance, but with the policies behind general tax doctrines, such as protection of federal tax revenues, promotion of certainty in tax planning, and encouragement of legitimate business transactions."[203] Tax judgment is required to ascertain those situations, but tax judgment about what is insurance should defer to the insurance domain to ascertain insurance situations because insurance can go far beyond what tax practitioners may think are core "commonly accepted" notions to insurance and insurable risks.

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[202] *See supra* note 128.
[203] Winslow, *supra* note 135, at 112 (citations omitted).