Internal Revenue bulletin

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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–85, page 986.
Section 368(a)(1)(D) reorganization. Guidance is provided as to whether a transaction otherwise qualifying under section 368(a)(1)(D) of the Code will be prevented from so qualifying when the acquiring corporation transfers the target corporation's assets to a subsidiary controlled by the acquiring corporation. Rev. Rul. 74–545 obsoleted.

Rev. Rul. 2002–87, page 989.
LIFO; price indexes; department stores. The October 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, October 31, 2002.

Rev. Rul. 2002–89, page 984.
Captive insurance. This ruling considers circumstances under which arrangements between a domestic parent corporation and its wholly owned insurance subsidiary constitute insurance for federal income tax purposes. Rev. Rul. 2001–31 amplified.

Rev. Rul. 2002–90, page 985.
Captive insurance. This ruling considers circumstances under which payments for professional liability coverage by a number of operating subsidiaries to an insurance subsidiary of a common parent constitute insurance for federal income tax purposes. Rev. Rul. 2001–31 amplified.

Rev. Rul. 2002–91, page 991.
Captive insurance; group captive. This ruling sets forth circumstances under which amounts paid to a group captive of unrelated insureds are deductible as insurance premiums and in which the group captive qualifies as an insurance company.

EMPLOYEE PLANS

Rev. Rul. 2002–88, page 995.
Duration of COBRA continuation coverage and divorce. This ruling provides guidance on when COBRA continuation coverage must commence if, in anticipation of divorce, an employee drops the coverage of a spouse under a group health plan of the employee's employer.

ESTATE TAX

Rev. Rul. 2002–86, page 993.
Combat zone-related deaths and deaths of victims of certain terrorist attacks. This ruling provides sample estate tax calculations, under section 2201 of the Code, for the estates of victims of specified terrorist attacks and members of the armed forces who died as a result of active service in a combat zone. Rev. Rul. 78–361 modified and superseded.

EXCISE TAX

Rev. Rul. 2002–88, page 995.
Duration of COBRA continuation coverage and divorce. This ruling provides guidance on when COBRA continuation coverage must commence if, in anticipation of divorce, an employee drops the coverage of a spouse under a group health plan of the employee's employer.

Announcement 2002–115, page 999.
The Service announces changes to excise tax rates effective after December 31, 2002.

Finding Lists begin on page ii.

(Continued on the next page)

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

Notice 2002–77, page 997.
The Service and the Department of Treasury announce their intention to amend section 1.367(a)–3(d) of the regulations to provide specifically that a U.S. person's exchange of stock or securities of a corporation (the "acquired corporation") for stock or securities of a foreign acquiring corporation in a reorganization under section 368(a)(1)(D) of the Code in which the foreign acquiring corporation transfers part or all of the acquired corporation's assets to a subsidiary, controlled by the acquiring corporation pursuant to the plan of reorganization, constitutes an indirect transfer of stock or securities by the U.S. person to the foreign acquiring corporation.

Rev. Proc. 2002–75, page 997.
Qualification as insurance. This procedure modifies Rev. Proc. 2002–3, 2002–1 I.R.B. 117, by removing sections 4.01(11) and 4.01(41) from the list of areas in which the Service ordinarily will not issue rulings or determination letters. These sections concerned whether there is adequate risk shifting and risk distribution for a transaction to constitute insurance for federal income tax purposes. Rev. Proc. 2002–3 modified.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 162.—Trade or Business Expenses

26 CFR 1.162–1: Business expenses.
(Also §§ 801, 831.)

Captive insurance. This ruling considers circumstances under which arrangements between a domestic parent corporation and its wholly owned insurance subsidiary constitute insurance for federal income tax purposes.

Rev. Rul. 2002–89

ISSUE

Are the amounts paid by a domestic parent corporation to its wholly owned insurance subsidiary deductible as "insurance premiums" under § 162 of the Internal Revenue Code?

FACTS

Situation 1. *P*, a domestic corporation, enters into an annual arrangement with its wholly owned domestic subsidiary *S* whereby *S* "insures" the professional liability risks of *P* either directly or as a reinsurer of these risks. *S* is regulated as an insurance company in each state where *S* does business.

The amounts *P* pays to *S* under the arrangement are established according to customary industry rating formulas. In all respects, the parties conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties.

In implementing the arrangement, *S* may perform all necessary administrative tasks, or it may outsource those tasks at prevailing commercial market rates. *P* does not provide any guarantee of *S*'s performance, and all funds and business records of *P* and *S* are separately maintained. *S* does not loan any funds to *P*.

In addition to the arrangement with *P*, *S* enters into insurance contracts whereby *S* serves as a direct insurer or a reinsurer of the professional liability risks of entities unrelated to *P* or *S*. The risks of unrelated entities and those of *P* are homogeneous. The amounts *S* receives from these unrelated entities under these insurance contracts likewise are established according to customary industry rating formulas.

The premiums *S* earns from the arrangement with *P* constitute 90% of *S*'s total premiums earned during the taxable year on both a gross and net basis. The liability coverage *S* provides to *P* accounts for 90% of the total risks borne by *S*.

Situation 2. Situation 2 is the same as Situation 1 except that the premiums *S* earns from the arrangement with *P* constitute less than 50% of *S*'s total premiums earned during the taxable year on both a gross and net basis. The liability coverage *S* provides to *P* accounts for less that 50% of the total risks borne by *S*.

LAW AND ANALYSIS

Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162–1(a) of the Income Tax Regulations provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business.

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The United States Supreme Court, however, has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. *Helvering v. LeGierse*, 312 U.S. 531 (1941).

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. *See Humana, Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989).

No court has held that a transaction between a parent and its wholly-owned subsidiary satisfies the requirements of risk shifting and risk distribution if only the risks of the parent are "insured." *See Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985); *Carnation Co. v. Commissioner*, 640 F.2d 1010 (9th Cir. 1981), *cert. denied* 454 U.S. 965 (1981). However, courts have held that an arrangement between a parent and its subsidiary can constitute insurance because the parent's premiums are pooled with those of unrelated parties if (i) insurance risk is present, (ii) risk is shifted and distributed, and (iii) the transaction is of the type that is insurance in the commonly accepted sense. *See, e.g., Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993); *AMERCO, Inc. v. Commissioner*, 979 F.2d 162 (9th Cir. 1992).

S is regulated as an insurance company in each state in which it transacts business, and the arrangements between *P* and *S* and between *S* and entities unrelated to *P* or *S* are established and conducted consistently with the standards applicable to an insurance arrangement. *P* does not guarantee *S*'s performance and *S* does not make any loans to *P*; *P*'s and *S*'s funds and records are separately maintained. The narrow question presented in *Situation 1* and *Situation 2* is whether *S* underwrites sufficient risks of unrelated parties that the arrangement between *P* and *S* constitutes insurance for federal income tax purposes.

In *Situation 1*, the premiums that *S* earns from its arrangement with *P* constitute 90% of its total premiums earned during the taxable year on both a gross and a net basis. The liability coverage *S* provides to *P* accounts for 90% of the total risks borne by *S*. No court has treated such an arrangement between a parent and its wholly-owned subsidiary as insurance. To the

contrary, the arrangement lacks the requisite risk shifting and risk distribution to constitute insurance for federal income tax purposes.

In *Situation 2*, the premiums that *S* earns from its arrangement with *P* constitute less than 50% of the total premiums *S* earned during the taxable year on both a gross and a net basis. The liability coverage *S* provides to *P* accounts for less than 50% of the total risks borne by *S*. The premiums and risks of *P* are thus pooled with those of the unrelated insureds. The requisite risk shifting and risk distribution to constitute insurance for federal income tax purposes are present. The arrangement is insurance in the commonly accepted sense.

HOLDINGS

In *Situation 1*, the arrangement between *P* and *S* does not constitute insurance for federal income tax purposes, and amounts paid by *P* to *S* pursuant to that arrangement are not deductible as "insurance premiums" under § 162.

In *Situation 2*, the arrangement between *P* and *S* constitutes insurance for federal income tax purposes, and the amounts paid by *P* to *S* pursuant to that arrangement are deductible as "insurance premiums" under § 162.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 2001–31, 2001–1 C.B. 1348, is amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is John E. Glover of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Mr. Glover at (202) 622–3970 (not a toll-free call).

Captive insurance. This ruling considers circumstances under which payments for professional liability coverage by a number of operating subsidiaries to an insurance subsidiary of a common parent constitute insurance for federal income tax purposes.

Rev. Rul. 2002–90

ISSUE

Are the amounts paid for professional liability coverage by domestic operating subsidiaries to an insurance subsidiary of a common parent deductible as "insurance premiums" under § 162 of the Internal Revenue Code?

FACTS

P, a domestic holding company, owns all of the stock of 12 domestic subsidiaries that provide professional services. Each subsidiary in the *P* group has a geographic territory comprised of a state in which the subsidiary provides professional services. The subsidiaries in the *P* group operate on a decentralized basis. The services provided by the employees of each subsidiary are performed under the general guidance of a supervisory professional for a particular facility of the subsidiary. The general categories of the professional services rendered by each of the subsidiaries are the same throughout the *P* group. Together the 12 subsidiaries have a significant volume of independent, homogeneous risks.

P, for a valid non-tax business purpose, forms *S* as a wholly-owned insurance subsidiary under the laws of State C. *P* provides *S* adequate capital and *S* is fully licensed in State *C* and in the 11 other states where the respective operating subsidiaries conduct their professional service businesses. *S* directly insures the professional liability risks of the 12 operating subsidiaries in the *P* group. *S* charges the 12 subsidiaries arms-length premiums, which are established according to customary industry rating formulas. None of the operating subsidiaries have liability coverage for less than 5%, nor more than 15%, of the total risk insured by *S*. *S* retains the risks that it insures from the 12 operating subsidiaries. There are no parental (or other related party) guarantees of any kind made in favor of *S*. *S* does not loan any funds to *P* or to the 12 operating subsidiaries. In all respects, the parties conduct themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties. *S* does not provide coverage to any entity other than the 12 operating subsidiaries.

LAW AND ANALYSIS

Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162–1(a) of the Income Tax Regulations provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business.

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The United States Supreme Court, however, has explained that in order for an arrangement to constitute "insurance" for federal income tax purposes, both risk shifting and risk distribution must be present. *Helvering v. LeGierse*, 312 U.S. 531 (1941).

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. *See Humana Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989).

In *Humana*, the United States Court of Appeals for the Sixth Circuit held that arrangements between a parent corporation and its insurance company subsidiary did not constitute insurance for federal income tax purposes. The court also held, however, that arrangements between the insurance company subsidiary and several dozen other subsidiaries of the parent (operating an even larger number of hospitals) qualified as insurance for federal

income tax purposes because the requisite risk shifting and risk distribution were present. *But see Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995) (concluding the lack of a business purpose, the undercapitalization of the offshore captive insurance subsidiary and the existence of related party guarantees established that the substance of the transaction did not support the taxpayer's characterization of the transaction as insurance). In *Kidde Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997), the United States Court of Federal Claims concluded that an arrangement between the captive insurance subsidiary and each of the 100 operating subsidiaries of the same parent constituted insurance for federal income tax purposes. As in *Humana*, the insurer in *Kidde* insured only entities within its affiliated group during the taxable years at issue.

In the present case, the professional liability risks of 12 operating subsidiaries are shifted to *S*. Further, the premiums of the operating subsidiaries, determined at arms-length, are pooled such that a loss by one operating subsidiary is borne, in substantial part, by the premiums paid by others. The 12 operating subsidiaries and *S* conduct themselves in all respects as would unrelated parties to a traditional insurance relationship, and *S* is regulated as an insurance company in each state where it does business. The narrow question presented is whether *P*'s common ownership of the 12 operating subsidiaries and *S* affects the conclusion that the arrangements at issue are insurance for federal income tax purposes. Under the facts presented, we conclude the arrangements between *S* and each of the 12 operating subsidiaries of *S*'s parent constitute insurance for federal income tax purposes.

HOLDING

The amounts paid for professional liability coverage by the 12 domestic operating subsidiaries to *S* are "insurance premiums" deductible under § 162.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 2001–31, 2001–1 C.B. 1348, is amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is William Sullivan of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Mr. Sullivan at (202) 622–3970 (not a toll-free call).

A revenue ruling that sets forth circumstances under which amounts paid to a group captive of unrelated insureds are deductible as insurance premiums. See Rev. Rul. 2002–91, page 991.

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1: Purpose and scope of exception for reorganization exchanges.

Section 368(a)(1)(D) reorganization. Guidance is provided as to whether a transaction otherwise qualifying under section 368(a)(1)(D) of the Code will be prevented from so qualifying when the acquiring corporation transfers the target corporation's assets to a subsidiary controlled by the acquiring corporation. Rev. Rul. 74–545 obsoleted.

Rev. Rul. 2002–85

ISSUE

Whether an acquiring corporation's transfer of a target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization will prevent a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) of the Internal Revenue Code from so qualifying.

FACTS

A, an individual, owns 100 percent of T, a state X corporation. A also owns 100 percent of P, a state Y corporation. For valid business reasons and pursuant to a plan of reorganization, (i) T transfers all of its assets to P in exchange for consideration consisting of 70 percent P voting stock and 30 percent cash, (ii) T then liquidates, distributing the P voting stock and cash to A, and (iii) P subsequently transfers all of the T assets to S, a preexisting, wholly owned state X subsidiary of P, in exchange for stock of S. S will continue T's historic business after the transfer and P will retain the S stock. Without regard to P's transfer of all the T assets to S, the transaction qualifies as a reorganization under § 368(a)(1)(D).

LAW

Section 368(a)(1)(D) provides that the term reorganization means a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under § 354, 355, or 356.

Section 354(a) provides that, in general, no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. Section 354(b)(1) provides that § 354(a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of § 368(a)(1) unless (A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Section 368(a)(2)(A) provides that if a transaction is described in both §§ 368 (a)(1)(C) and 368(a)(1)(D), then, for purposes of subchapter C (other than for purposes of § 368(a)(2)(C)), such transaction shall be treated as described only in § 368(a)(1)(D).

Section 368(a)(2)(C) provides that a transaction otherwise qualifying under § 368(a)(1)(A), (B), (C), or (G) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled (as defined in § 368(c)) by the corporation acquiring such assets or stock.

Section 368(b) provides that the term "a party to a reorganization" includes a corporation resulting from a reorganization, and both corporations in the case of a reorga-

nization resulting from the acquisition by one corporation of the properties of another.

Congress enacted § 368(a)(2)(C) in response to the Supreme Court decisions in *Groman v. Commissioner*, 302 U.S. 82 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938). In *Groman*, the shareholders of one corporation (Target) entered into an agreement with another corporation (Parent) pursuant to which Target would merge into Parent's newly formed subsidiary (Sub). In the transaction, the Target shareholders transferred their Target shares to Sub in exchange for shares of Parent, shares of Sub, and cash, and Target liquidated. The Court concluded that, even though the statutory definition of "party to a reorganization" was not exclusive, Parent was not a party to the reorganization because it received nothing in the exchange. The Court then stated that an exchange that is pursuant to a plan of reorganization is not taxable to the extent the interest of the stockholders of a corporation continue to be definitely represented in substantial measure in a new or different corporation. The stock of Parent, however, did not represent a continued substantial interest in the assets conveyed to Sub. Because Parent was not a party to the reorganization, the Court held that the receipt of the stock of Parent was taxable.

In *Bashford*, a corporation (Parent) wished to acquire three competitors (Targets). Pursuant to a plan, Parent formed a new corporation (Sub) and acquired all the preferred shares and a majority of the common shares of Sub. Sub became the owner of the stock and assets of the Targets. The former stockholders of the Targets exchanged their shares in the Targets for shares of Sub, shares of Parent, and cash. Because any direct ownership by Parent of the Targets was transitory and without real substance, the Court saw no significant distinction between this transaction and the transaction in *Groman*. Therefore, the Court concluded that Parent was not a party to the reorganization. Hence, the Parent stock received by the shareholders of the Targets did not confer the requisite continuity of interest.

In 1954, Congress enacted § 368(a)(2)(C) in response to *Groman* and *Bashford*. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 52, 273, 275 (1954). As originally enacted, § 368(a)(2)(C) applied only to reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C), but Congress has since amended the statute to apply to other reorganizations. Specifically, Congress amended § 368(a)(2)(C) in 1964 to apply to reorganizations under § 368(a)(1)(B), and, in 1980, to reorganizations under § 368(a)(1)(G).

Section 1.368–2(k)(1) of the Income Tax Regulations restates the general rule of § 368(a)(2)(C) but permits the assets or stock acquired in certain types of reorganizations to be successively transferred to one or more corporations controlled (as defined in § 368(c)) in each transfer by the transferor corporation without disqualifying the reorganization.

Section 1.368–2(f) provides that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though the stock or assets acquired in the reorganization are transferred in a transaction described in § 1.368–2(k).

To qualify as a reorganization under § 368, a transaction must satisfy the continuity of business enterprise (COBE) requirement. The COBE requirement is intended to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form. Section 1.368–1(d)(1). Section 1.368–1(d)(1) provides that COBE requires the issuing corporation (generally the acquiring corporation) in a potential reorganization to either continue the target corporation's historic business or use a significant portion of the target's historic business assets in a business. Pursuant to § 1.368–1(d)(4)(i), the issuing corporation is treated as holding all of the businesses and assets of all members of its qualified group. Section 1.368–1(d)(4)(ii) defines a qualified group as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of § 368(c) in at least one other corporation, and stock meeting the requirements of § 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

In Rev. Rul. 88–48, 1988–1 C.B. 117, in a taxable transaction, corporation X sold 50 percent of its historic business assets to unrelated purchasers for cash. Immediately afterwards, pursuant to an overall plan, X transferred to corporation Y, a corporation unrelated to X and the purchasers, all of its assets, including the cash from the sale. The ruling holds that X's transfer of assets to Y satisfied the substantially all requirement of § 368(a)(1)(C).

In Rev. Rul. 2001–25, 2001–1 C.B. 1291, pursuant to a plan, corporation S, a wholly owned subsidiary of corporation P, merged with and into corporation T in a state law merger. Immediately after the merger and as part of a plan that included the merger, T sold 50 percent of its operating assets for cash to an unrelated corporation. After the sale of the assets to corporation X, T retained the sales proceeds. Without regard to the requirement that T hold substantially all of the assets of T and S immediately after the merger, the merger satisfied all the other requirements applicable to reorganizations under §§ 368(a)(1)(A) and 368(a)(2)(E). The Service ruled that even though T's post-merger sale of 50 percent of its operating assets prevented T from holding substantially all of its historic business assets immediately after the merger, because the sales proceeds continued to be held by T, the merger did not violate the requirement of § 368(a)(2)(E) that the surviving corporation hold substantially all of its properties after the transaction.

In Rev. Rul. 2001–24, 2001–1 C.B. 1290, corporation X merged with and into corporation S, a newly organized, wholly owned subsidiary of corporation P, in a transaction intended to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D). S continued the historic business of X following the merger. Following the merger and as part of the plan of reorganization, P transferred the S stock to corporation S1, a preexisting, wholly owned subsidiary of P. The Service ruled that the transaction satisfied the continuity of business enterprise requirement of § 1.368–1(d). Analyzing whether P's transfer of the S stock to S1 caused P to fail to control S for purposes of § 368(a)(2)(D) and caused P to fail to be a party to the reorganization, the Service noted that the legislative history of § 368(a)(2)(E) suggests that forward and reverse triangular mergers should be treated similarly. Section 1.368–2(k)(2) permits the transfer of stock or assets to a controlled corporation following a reverse triangular merger under §§ 368(a)(1)(A) and

368(a)(2)(E), which supports permitting P to transfer the S stock to S1 without causing the transaction to fail to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D). Furthermore, although §§ 368(a)(2)(C) and 1.368–2(k) do not specifically address P's transfer of S stock to S1 following a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D), § 368 (a)(2)(C) is permissive rather than exclusive or restrictive. Accordingly, the Service concluded that the transfer of the S stock to S1 would not cause P to be treated as not in control of S for purposes of § 368(a)(2)(D) and would not cause P to fail to be treated as a party to the reorganization.

ANALYSIS

Neither § 368(a)(2)(C) nor § 368(a)(2)(A) indicates that an acquiring corporation's transfer of assets to a controlled subsidiary necessarily prevents a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) from so qualifying. Because § 368(a)(2)(C) is permissive and not exclusive or restrictive, the absence of § 368(a)(1)(D) from § 368(a)(2)(C) does not indicate that such a transfer following a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) will prevent the transaction from qualifying as such. Furthermore, although § 368(a)(2)(A) contains the parenthetical exception "other than for purposes of [§ 368(a)(2)(C)]," that exception appears to have been provided in the same spirit as § 368(a)(2)(C), *i.e.*, to resolve doubts about the qualification of transactions as reorganizations, and does not indicate that the transfer of assets to a controlled subsidiary necessarily prevents a transaction from qualifying as a reorganization under § 368(a)(1)(D). *See* S. Rep. No. 313, 99th Cong., 2d Sess. 914 (1986).

Accordingly, an acquiring corporation's transfer of assets to a controlled subsidiary following a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) will not cause a transaction to fail to qualify as such, provided that the original transferee is treated as acquiring substantially all of the assets of the target corporation, the transaction satisfies the COBE requirement and does not fail under the remote continuity principle of *Groman* and *Bashford*, and the transfer of assets to a controlled corporation does not prevent the original transferee from being a "party to the reorganization."

Section 354(b)(1)(A) requires that, in a reorganization under § 368(a)(1)(D), the corporation to which the assets are transferred acquire substantially all of the assets of the transferor of such assets. In this case, the requirement that P acquire substantially all of T's assets is satisfied because P retains the stock of S. *See* Rev. Rul. 2001–24; Rev. Rul. 88–48.

To qualify as a reorganization under § 368(a)(1)(D), a transaction must satisfy the COBE requirement of § 1.368–1(d). In the present transaction, P and S constitute a qualified group, and S will continue T's historic business after the transfer. Therefore, the transaction satisfies the COBE requirement.

As described above, Congress enacted § 368(a)(2)(C) in response to the Supreme Court's holdings in *Groman* and *Bashford*. After the enactment of § 368(a)(2)(C), however, the Service continued to apply the principles of *Groman* and *Bashford* to transactions that otherwise qualified as reorganizations under § 368(a)(1)(B). *See* Rev. Rul. 63–234, 1963–2 C.B. 148. In response to this position, Congress expanded the scope of § 368(a)(2)(C) to include reorganizations under § 368(a)(1)(B). Congress' response to the application of the principles of *Groman* and *Bashford* has been to limit the application of those principles. Implicit in Congress' enactment and expansion of § 368(a)(2)(C) is a rejection of the principle that the transfer of acquired stock or assets to a controlled subsidiary of the acquiring corporation creates a remote continuity problem that causes a transaction that otherwise qualifies as a reorganization to fail to so qualify. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A134 (1954) (stating, after citing *Groman* and *Bashford* in reference to proposed legislation that ultimately became § 368(a)(2)(C), "a corporation may not acquire assets with the intention of transferring them to a stranger").

Under the COBE regulations, stock or assets acquired in transactions that satisfy certain provisions of § 368(a)(1) may be transferred without limitation to successive lower-tier controlled subsidiaries within a qualified group. The Preamble to the final COBE regulations states that "the IRS and Treasury believe the COBE requirements adequately address the issues raised in *Groman* and *Bashford* and their progeny. Thus, [the final COBE regulations] do not separately articulate rules addressing remote continuity of interest." T.D. 8760, 1998–1 C.B. 803, Supplementary Information (Explanation of Provisions). Accordingly, a transfer of acquired stock or assets will not cause a transaction to fail for remote continuity if it satisfies the COBE requirement.

Under the facts described above, P's transfer of the T assets to S pursuant to the plan of reorganization satisfies the COBE requirement. Therefore, the transaction does not fail for remote continuity.

Section 368(b) provides that the term "a party to a reorganization" includes a corporation resulting from a reorganization, and both corporations in the case of a reorganization resulting from the acquisition by one corporation of the properties of another. The use of the word "includes" in § 368(b) indicates that the definition of "party to a reorganization" is not exclusive. *See* § 7701(c); *Groman*, *supra*, at 86 (stating that "when an exclusive definition is intended the word 'means' is employed . . . whereas [in the definition of "party to a reorganization"] the word used is 'includes'"). Furthermore, § 1.368–2(f), which interprets § 368(b), provides that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to a reorganization even though the stock or assets acquired in the reorganization are transferred in a transaction described in § 1.368–2(k). Section 1.368–2(k) does not reference § 368(a)(1)(D). Nonetheless, because § 1.368–2(k) restates and interprets § 368(a)(2)(C), which is a permissive and not an exclusive or restrictive provision, § 1.368–2(k) also should be viewed as permissive and not exclusive or restrictive. Therefore, because §§ 368(b), 1.368–2(f), and 1.368–2(k) are not exclusive or restrictive provisions, the absence of § 368(a)(1)(D) from § 1.368–2(k) does not prevent a corporation from remaining a party to a reorganization even if the acquired stock or assets are transferred to a controlled subsidiary.

Reorganizations under § 368(a)(1)(D), like reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C), are asset reorganizations. In reorganizations under §§ 368 (a)(1)(A) and 368(a)(1)(C), the original transferee is treated as a party to a reorganization, even if the acquired assets are transferred to a controlled subsidiary of the

original transferee. The differences between reorganizations under § 368(a)(1)(D) on the one hand and reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C) on the other hand do not warrant treating the original transferee in a transaction that otherwise satisfies the requirements of a reorganization under § 368(a)(1)(D) differently from the original transferee in a reorganization under § 368(a)(1)(A) or 368(a)(1)(C) for purposes of § 368(b). Therefore, the original transferee in a transaction that otherwise satisfies the requirements of a reorganization under § 368(a)(1)(D) is treated as a party to the reorganization, notwithstanding the original transferee's transfer of acquired assets to a controlled subsidiary of the original transferee.

For the reasons set forth above, P's transfer of the T assets to S will not prevent P's acquisition of those assets from T in exchange for P voting stock and cash from qualifying as a reorganization under § 368(a)(1)(D).

HOLDING

An acquiring corporation's transfer of the target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization will not prevent a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) from so qualifying.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 74–545, 1974–2 C.B. 122, is obsoleted. In Rev. Rul. 74–545, the Service ruled that, for purposes of § 368(a)(2)(A), a transaction that qualified as a reorganization under § 368(a)(1)(C) was "described in" § 368(a)(1)(D) even though it did not qualify as a reorganization under § 368(a)(1)(D). In that ruling, the target corporation did not satisfy the requirement of § 354(b)(1)(B) because it did not distribute all of its remaining assets along with the stock of the acquiring corporation. The Service reasoned that the purpose of § 368(a)(2)(A) was to ensure that divisive transactions would not be able to avoid the requirements of § 355 by qualifying as a reorganization under § 368(a)(1)(C). Congress, however, resolved this problem in 1984 when it added § 368(a)(2)(G), which requires the target corporation in a reorganization under § 368(a)(1)(C) to distribute the stock, securities, and other properties that it receives, as well as its other properties, in pursuance of the plan of reorganization. This distribution requirement prevents divisive reorganizations that are "described in" § 368(a)(1)(D) from qualifying as reorganizations under § 368(a)(1)(C). Therefore, Rev. Rul. 74–545 is obsolete.

APPLICATION

Pursuant to § 7805(b)(8), the Service will not apply the principles of this revenue ruling to challenge a taxpayer's position that a transaction that occurs on or before December 9, 2002, or a transaction that is effected pursuant to a written agreement (subject to customary conditions) that is binding on December 9, 2002, and at all times thereafter until the date of the transaction does not qualify as a reorganization under § 368(a)(1)(D), provided that, if the taxpayer is the acquiring corporation (or a shareholder of the acquiring corporation whose tax treatment of the transaction reflects the tax treatment by the acquiring corporation, such as a shareholder of an acquiring S corporation), the target corporation (and the shareholders of the target corporation whose tax treatment of the transaction reflects the tax treatment by the target corporation) also treats the transaction as not qualifying as a reorganization under § 368(a)(1)(D) for Federal income tax purposes, and if the taxpayer is the target corporation (or a shareholder of the target corporation whose tax treatment of the transaction reflects the tax treatment by the target corporation), the acquiring corporation (and the shareholders of the acquiring corporation whose tax treatment of the transaction reflects the tax treatment by the acquiring corporation) also treats the transaction as not qualifying as a reorganization under § 368(a)(1)(D) for Federal income tax purposes.

In addition, if a U.S. person that is a shareholder of a target corporation has taken a position consistent with the principles of this revenue ruling for a transfer occurring on or after July 20, 1998, and on or before December 9, 2002, which transfer involved the U.S. person's exchange of stock or securities of the target corporation for stock or securities of a foreign acquiring corporation in which the foreign acquiring corporation transferred part or all of the acquired corporation's assets to a subsidiary controlled by the acquiring corporation as part of the plan of reorganization, then such transfer constituted an indirect transfer of stock or securities by the U.S. person to the foreign acquiring corporation. *See* §§ 1.367(a)–1T(c) and 1.367(a)–3(d). To the extent such U.S. person has not entered into a gain recognition agreement (GRA) satisfying the requirements of § 1.367(a)–3(b)(1)(ii) or 1.367(a)–3(c)(1)(iii)(B) in connection with a transfer for which the U.S. person has taken a position consistent with the principles of this revenue ruling, the U.S. person will be treated as having timely satisfied the requirements for such a GRA if such U.S. person attaches a GRA that otherwise complies with the requirements of § 1.367(a)–8 to its timely filed (including extensions) original tax return for the taxable year that includes December 9, 2002.

Further, the Service and the Treasury are considering amending the regulations under § 368 to reflect the principles of this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Karen Lau of the Office of Chief Counsel. For further information regarding this revenue ruling, contact Ms. Lau at (202) 622–3300 (not a toll-free call).

Section 472.—Last in, First-out Inventories

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The October 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, October 31, 2002.

Rev. Rul. 2002–87

The following Department Store Inventory Price Indexes for October 2002 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the

Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, October 31, 2002.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups		Oct. 2001	Oct. 2002	Percent Change from Oct. 2001 to Oct. 2002[1]
1.	Piece Goods	500.3	485.7	–2.9
2.	Domestics and Draperies	592.0	581.6	–1.8
3.	Women's and Children's Shoes	675.5	660.4	–2.2
4.	Men's Shoes	872.5	895.6	2.6
5.	Infants' Wear	631.1	628.9	–0.3
6.	Women's Underwear	575.3	544.2	–5.4
7.	Women's Hosiery	358.0	339.8	–5.1
8.	Women's and Girls' Accessories	573.7	551.6	–3.9
9.	Women's Outerwear and Girls' Wear	398.4	388.2	–2.6
10.	Men's Clothing	587.3	573.0	–2.4
11.	Men's Furnishings	628.2	599.3	–4.6
12.	Boys' Clothing and Furnishings	490.5	459.4	–6.3
13.	Jewelry	919.6	897.1	–2.4
14.	Notions	797.1	808.9	1.5
15.	Toilet Articles and Drugs	981.6	975.1	–0.7
16.	Furniture and Bedding	628.8	626.4	–0.4
17.	Floor Coverings	616.0	592.6	–3.8
18.	Housewares	767.1	745.8	–2.8
19.	Major Appliances	224.1	223.7	–0.2
20.	Radio and Television	52.6	47.6	–9.5
21.	Recreation and Education[2]	89.2	85.2	–4.5
22.	Home Improvements[2]	125.4	124.6	–0.6
23.	Auto Accessories[2]	110.2	111.3	1.0
Groups 1 – 15: Soft Goods		598.6	582.7	–2.7
Groups 16 – 20: Durable Goods		419.1	407.4	–2.8
Groups 21 – 23: Misc. Goods[2]		98.2	95.7	–2.5
	Store Total[3]	532.4	518.1	–2.7

[1] Absence of a minus sign before the percentage change in this column signifies a price increase.

[2] Indexes on a January 1986=100 base.

[3] The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7718 (not a toll-free call).

Section 692.—Income Taxes of Members of Armed Forces and Victims of Certain Terrorist Attacks on Death

How does the estate of a "qualified decedent," as defined in secton 2201(b) of the Internal Revenue Code, compute the federal estate tax under section 2201, as amended by the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107–134, section 103, 115 Stat. 2427 (2002)? See Rev. Rul. 2002–86, page 993.

Section 801.—Tax Imposed

26 CFR 1.801–3: Definitions.

A revenue ruling that sets forth circumstances under which arrangements between a domestic parent corporation and its wholly owned insurance subsidiary constitute insurance for Federal income tax purposes. See Rev. Rul. 2002–89, page 984.

Whether a transaction where amounts are paid for professional liability coverage by a number of domestic operating subsidiaries to an insurance subsidiary of a common parent constitutes insurance for Federal income tax purposes? See Rev. Rul. 2002–90, page 985.

A revenue ruling that sets forth circumstances under which a group captive of unrelated insureds qualifies as an insurance company. See Rev. Rul. 2002–91, on this page.

Section 831.—Tax on Insurance Companies Other Than Life Insurance Companies

26 CFR 1.831–3: Tax on insurance companies (other than life or mutual), mutual marine insurance companies, mutual fire insurance companies issuing perpetual policies, and mutual fire and flood insurance companies operating on the basis of premium deposits; taxable years beginning after December 31, 1962.

A revenue ruling that sets forth circumstances under which arrangements between a domestic parent corporation and its wholly owned insurance subsidiary constitute insurance for Federal income tax purposes. See Rev. Rul. 2002–89, page 984.

Whether a transaction where amounts are paid for professional liability coverage by a number of domestic operating subsidiaries to an insurance subsidiary of a common parent constitutes insurance for Federal income tax purposes? See Rev. Rul. 2002–90, page 985.

(Also §§ 162, 801; 1.162–1, 1.801–3.)

Captive insurance; group captive. This ruling sets forth circumstances under which amounts paid to a group captive of unrelated insureds are deductible as insurance premiums and in which the group captive qualifies as an insurance company.

Rev. Rul. 2002–91

ISSUE

Whether a "group captive" formed by a relatively small group of unrelated businesses involved in a highly concentrated industry to provide insurance coverage is an insurance company within the meaning of § 831 of the Internal Revenue Code under the circumstances described below.

FACTS

X is one of a small group of unrelated businesses involved in one highly concentrated industry. Businesses involved in this industry face significant liability hazards. *X* and the other businesses involved in this industry are required by regulators to maintain adequate liability insurance coverage in order to continue to operate. Businesses that participate in this industry have sustained significant losses due to the occurrence of unusually severe loss events. As a result, affordable insurance coverage for businesses that participate in this industry is not available from commercial insurance companies.

X and a significant number of the businesses involved in this industry (Members) form a so-called "group captive" (*GC*) to provide insurance coverage for stated liability risks. *GC* provides insurance only to *X* and the other Members. The business operations of *GC* are separate from the business operation of each Member. *GC* is adequately capitalized.

No Member owns more than 15% of *GC*, and no Member has more than 15% of the vote on any corporate governance issue. In addition, no Member's individual risk insured by *GC* exceeds 15% of the total risk insured by *GC*. Thus, no one member controls *GC*.

GC issues insurance contracts and charges premiums for the insurance coverage provided under the contracts. *GC* uses recognized actuarial techniques, based, in part, on commercial rates for similar coverage, to determine the premiums to be charged to an individual Member.

GC pools all the premiums it receives in its general funds and pays claims out of those funds. *GC* investigates any claim made by a Member to determine the validity of the claim prior to making any payment on that claim. *GC* conducts no other business than the issuing and administering of insurance contracts.

No Member has any obligation to pay *GC* additional premiums if that Member's actual losses during any period of coverage exceed the premiums paid by that Member. No Member will be entitled to a refund of premiums paid if that Member's actual losses are lower than the premiums paid for coverage during any period. Premiums paid by any Member may be used to satisfy claims of the other Members. No Member that terminates its insurance coverage or sells its ownership interest in *GC* is required to make additional premium or capital payments to *GC* to cover losses in excess of its premiums paid. Moreover, no Member that terminates its coverage or disposes of its ownership interest in *GC* is entitled to a refund of premiums paid in excess of insured losses.

LAW AND ANALYSIS

Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162–1(a) of the Income Tax Regulations provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business.

Section 831(a) of the Code provides that taxes computed under section 11 are im-

posed for each tax year on the taxable income of every insurance company other than a life insurance company.

Section 1.801–3(a) provides that an insurance company is "a company whose primary and predominant business activity is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The United States Supreme Court, however, has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. *Helvering v. LeGierse*, 312 U.S. 531 (1941).

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. *See Humana, Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989).

No court has held that a transaction between a parent and its wholly-owned subsidiary satisfies the requirements of risk shifting and risk distribution if only the risks of the parent are "insured." *See Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985); *Carnation Co. v. Commissioner*, 640 F.2d 1010 (9th Cir. 1981), *cert. denied*, 454 U.S. 965 (1981). However, courts have held that an arrangement between a parent and its subsidiary can constitute insurance because the parent's premiums are pooled with those of unrelated parties if (i) insurance risk is present, (ii) risk is shifted and distributed, and (iii) the transaction is of the type that is insurance in the commonly accepted sense. *See, e.g., Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993); *AMERCO, Inc. v. Commissioner*, 979 F.2d 162 (9th Cir. 1992).

Additional factors to be considered in determining whether a captive insurance transaction is insurance include: whether the parties that insured with the captive truly face hazards; whether premiums charged by the captive are based on commercial rates; whether the validity of claims was established before payments are made; and whether the captive's business operations and assets are kept separate from the business operations and assets of its shareholders. *Ocean Drilling & Exploration Co*. at 1151.

In Rev. Rul. 2001–31, 2001–1 C.B.1348, the Service stated that it will not invoke the economic family theory in Rev. Rul. 77–316 with respect to captive insurance arrangements. Rev. Rul. 2001–31 provides, however, that the Service may continue to challenge certain captive insurance transactions based on the facts and circumstances of each case.

Rev. Rul. 78–338, 1978–2 C.B.107, presented a situation in which 31 unrelated corporations created a group captive insurance company to provide those corporations with insurance that was not otherwise available. In that ruling, none of the unrelated corporations held a controlling interest in the group captive. In addition, no individual corporation's risk exceeded 5 percent of the total risks insured by the group captive. The Service concluded that because the corporations that owned, and were insured by, the group captive were not economically related, the economic risk of loss could be shifted and distributed among the shareholders that comprised the insured group.

X and the other Members face true insurable hazards. *X* and the other Members are required to maintain general liability insurance coverage in order to continue to operate in their industry. *X* and the other Members are unable to obtain affordable insurance from unrelated commercial insurers due to the occurrence of unusually severe loss events. Notwithstanding the fact that the group of Members is small, there is a real possibility that a Member will sustain a loss in excess of the premiums it paid. No individual Member will be reimbursed for premiums paid in excess of losses sustained by that Member. Finally, *X* and the other Members are unrelated. Therefore, the contracts issued by *GC* to *X* and the other Members are insurance contracts for federal income tax purposes, and the premiums paid by the Members are deductible under § 162.

GC is an entity separate from its owners. *GC* is adequately capitalized. *GC* issues insurance contracts, charges premiums, and pays claims after investigating the validity of the claim. *GC* will not engage in any business activities other than issuing and administering insurance contracts. Premiums charged by *GC* will be actuarially determined using recognized actuarial techniques, and will be based, in part, on commercial rates. As *GC*'s only business activity is the business of insurance, it is taxed as an insurance company.

HOLDING

The arrangement between *X* and *GC* constitutes insurance for federal income tax purposes, and the amounts paid as "insurance premiums" by *X* to *GC* pursuant to that arrangement are deductible as ordinary and necessary business expenses. *GC* is in the business of issuing insurance and will be treated as an insurance company taxable under § 831.

DRAFTING INFORMATION

The principal author of this revenue ruling is Melissa Luxner of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Ms. Luxner at (202) 622–3142 (not a toll-free call).

Section 2001.—Imposition and Rate of Tax

26 CFR 20.2001–1: Valuation of adjusted taxable gifts and section 2701(d) taxable events.

How does the estate of a "qualified decedent," as defined in section 2201(b) of the Internal Revenue Code, compute the federal estate tax under section 2201, as amended by the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107–134, section 103, 115 Stat. 2427 (2002)? See Rev. Rul. 2002–86, page 993.

Section 2010.—Unified Credit Against Estate Tax

How does the estate of a "qualified decedent," as defined in section 2201(b) of the Internal Revenue Code, compute the federal estate tax under section 2201, as amended by the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107–134, section 103, 115 Stat. 2427 (2002)? See Rev. Rul. 2002–86, on this page.

Section 2011.—Credit for State Death Taxes

26 CFR 20.2011–1: Credit for state death taxes.

How does the estate of a "qualified decedent," as defined in section 2201(b) of the Internal Revenue Code, compute the federal estate tax under section 2201, as amended by the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107–134, section 103, 115 Stat. 2427 (2002)? See Rev. Rul. 2002–86, on this page.

Section 2058.—State Death Taxes

How does the estate of a "qualified decedent," as defined in section 2201(b) of the Internal Revenue Code, compute the federal estate tax under section 2201, as amended by the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107–134, section 103, 115 Stat. 2427 (2002)? See Rev. Rul. 2002–86, on this page.

Section 2201.—Combat Zone-Related Deaths of Members of the Armed Forces and Deaths of Victims of Certain Terrorist Attacks

26 CFR 20.2201–1: Members of the Armed Forces dying during an induction period.
(Also §§ 692, 2001, 2010, 2011, 2058, 6018; 20.2001–1, 20.2011–1.)

Combat zone-related deaths and deaths of victims of certain terrorist attacks. This ruling provides sample estate tax calculations, under section 2201 of the Code, for the estates of victims of specified terrorist attacks and members of the armed forces who died as a result of active service in a combat zone.

Rev. Rul. 2002–86

ISSUE

How does the estate of a "qualified decedent," as defined in § 2201(b) of the Internal Revenue Code, compute the federal estate tax under § 2201, as amended by the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107–134, § 103, 115 Stat. 2427 (2002)?

FACTS

D, a resident of state *X*, is a qualified decedent. During *D*'s lifetime, *D* did not make any adjusted taxable gifts (defined in § 2001(b)). In filing Form 706, the *United States Estate (and Generation-Skipping Transfer) Tax Return*, *D*'s executor does not elect out of the application of § 2201(a). *D*'s estate pays the applicable state death tax imposed by state *X*.

Situation 1. D died in 2001, a year in which state *X* imposed a state death tax equal to the state death tax credit allowable under § 2011(a). The amount of *D*'s taxable estate is $2,936,818.

Situation 2. The facts are the same as in *Situation 1*, except that the amount of *D*'s taxable estate is $8,762,500.

Situation 3. D dies in 2005, a year in which state *X* imposes a state death tax equal to the state death tax credit that would have been allowable under § 2011(a) as it existed prior to the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107–16, 115 Stat. 38 (2001). The amount of *D*'s taxable estate before the deduction for state death taxes is $5,953,939.

LAW AND ANALYSIS

Section 2001(a) imposes an estate tax on the transfer of the taxable estate of every decedent who is a U.S. citizen or resident. The estate tax is computed using the rate schedule contained in § 2001(c).

Section 2201(a) provides that for purposes of computing the federal estate tax of the estate of a qualified decedent, the rate schedule set forth in § 2201(c) shall be used instead of the rate schedule contained in § 2001(c), unless the executor of the estate elects not to have § 2201 apply.

Under § 2201(b), a qualified decedent is: (1) any citizen or resident of the United States dying while in active service of the Armed Forces of the United States, if the decedent (a) was killed in action while serving in a combat zone, or (b) died as a result of wounds, disease, or injury suffered, while serving in a combat zone, and while in the line of duty, by reason of a hazard to which the decedent was subjected as an incident of the service; and (2) any specified terrorist victim, as defined by § 692(d)(4).

Under § 692(d)(4), a "specified terrorist victim" is any decedent who dies as a result of wounds or injury incurred as a result of the terrorist attacks against the United States on April 19, 1995, or September 11, 2001, or who dies as a result of illness incurred as a result of an attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002. Any individual identified by the Attorney General to have been a participant or conspirator in any such attack or a representative of either is not a specified terrorist victim.

If § 2201 applies, the estate tax (including the aggregate amount of gift tax payable on any adjusted taxable gifts under § 2001(b)(2)) is computed in the same manner as provided in § 2001(b), except that the rate schedule provided in § 2201(c) is used to compute the tax instead of the rate schedule in § 2001(c). The rate schedule contained in § 2001(c) continues to be used to determine the applicable credit amount (the unified credit) available to the estate under § 2010(c).

Section 2011(f), added by EGTRRA § 532(a) as § 2011(g) and redesignated as § 2011(f) by the Victims of Terrorism Tax Relief Act of 2001 § 103(b)(1), provides that the state death tax credit under § 2011 will not be allowable to the estates of decedents dying after December 31, 2004. Instead, the estates of decedents dying after that date will be allowed a deduction under § 2058(a) for estate and inheritance taxes actually paid to any state or the District of Columbia in respect of any property included in the gross estate. Thus, beginning in 2005, no state death taxes will be owed by a decedent's estate to a jurisdiction that imposes a death tax only equal to the allowable federal credit for state death taxes.

Many states, however, impose state death taxes based on the state death tax credit computed under § 2011 as it existed prior to the passage of EGTRRA or on some other basis unrelated to the amount of any

federal credit. Beginning in 2005, state death taxes paid to these jurisdictions will be deductible in computing a decedent's taxable estate, provided all the requirements of § 2058 are satisfied. These state death taxes will reduce an estate's federal estate tax liability but will increase the total death tax liability.

In *Situation 1* and *Situation 2*, *D* died in 2001, a year in which a state death tax credit was allowable under § 2011 and state *X* imposed a state death tax equal to the allowable § 2011 credit. Accordingly, in *Situation 1*, *D*'s estate will have no federal estate tax liability and no state death tax liability, as follows:

Taxable Estate	$	2,936,818
Tentative Estate Tax Computed under Rate Schedule in § 2201(c)	$	220,550
Less: Allowable Unified Credit under § 2010(a) and (c)	$	(220,550)
Subtotal	$	0
Less: State Death Tax Credit under § 2011 in Excess of Subtotal	$	(0)
Federal Estate Tax	$	0

In *Situation 2*, *D*'s estate will have no federal estate tax liability but will have a state death tax liability of $882,200, as follows:

Taxable Estate	$	8,762,500
Tentative Estate Tax Computed under Rate Schedule in § 2201(c)	$	1,102,750
Less: Allowable Unified Credit under § 2010(a) and (c)	$	(220,550)
Subtotal	$	882,200
Less: State Death Tax Credit under § 2011	$	(882,200)
Federal Estate Tax	$	0

In *Situation 3*, *D* dies in 2005, a year in which state death taxes qualify for a deduction under § 2058, rather than a credit under § 2011. State *X* imposes a state death tax equal to the credit that would have been allowable under § 2011 prior to amendments by EGTRRA. Accordingly, *D*'s estate will have no federal estate tax liability but will pay a state death tax of $505,273, as follows:

Taxable Estate Before Application of the § 2058 Deduction	$	5,953,939
Deduction for State Death Taxes Paid under § 2058	$	(505,273)
Taxable Estate	$	5,448,666
Tentative Estate Tax Computed under Rate Schedule in § 2201(c)	$	555,800
Less: Allowable Unified Credit under § 2010(a) and (c)	$	(555,800)
Federal Estate Tax	$	0

Under § 6018(a)(1), a Form 706 must be filed for the estate of a decedent who is a U.S. citizen or resident who dies in 2001 if the gross estate exceeds $675,000 (the applicable credit amount). This amount increases to $1,000,000 in years 2002–2003, $1,500,000 in years 2004–2005, $2,000,000 in years 2006–2008, and $3,500,000 in year 2009. (The applicable credit amount for non-resident non-citizens is lower than these amounts.) Accordingly, in *Situations 1*, *2*, and *3*, *D*'s estate must file a Form 706 notwithstanding that no federal estate tax is due.

HOLDINGS

In *Situations 1* and *2*, no federal estate tax is due for a qualifying decedent who died in the year 2001 if the taxable estate is not more than $8,762,500 and the state imposes a death tax that is at least equal to the state death tax credit under § 2011. If the taxable estate exceeds $2,936,818, however, a state death tax will be due.

In *Situation 3*, under current law, no federal estate tax will be due for a qualifying decedent who dies in the year 2005 if the taxable estate before the deduction for state death taxes does not exceed $5,953,939 and the state imposes a state death tax equal to the state death tax credit under § 2011 as it existed prior to EGTRRA. However, the state death tax will be due.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78–361, 1978–2 C.B. 246, is modified and superseded.

DRAFTING INFORMATION

The principal author of this revenue ruling is Mayer Samuels of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Samuels at (202) 622–3090 (not a toll-free call).

Section 4980B.—Continuation Coverage Requirements of Group Health Plans

26 CFR 54.4980B–7: Duration of COBRA continuation coverage.

Duration of COBRA continuation coverage and divorce. This ruling provides guidance on when COBRA continuation coverage must commence if, in anticipation of divorce, an employee drops the coverage of a spouse under a group health plan of the employee's employer.

Rev. Rul. 2002–88

ISSUE

If an employee eliminates the coverage of the employee's spouse under a group health plan in anticipation of their divorce, when must a plan that is required to make COBRA continuation coverage available to the spouse begin to make that coverage available?

FACTS

A group health plan subject to COBRA allows eligible employees to elect coverage for themselves and their spouses. An employee who has elected coverage for the employee's spouse can notify the plan to eliminate the spouse's coverage, and the spouse's coverage will be terminated as of the end of the month in which the notice is provided. Under the terms of the plan, a spouse loses eligibility for coverage on the date of divorce from an eligible employee.

Employee *E* is enrolled in the group health plan and elected coverage for *E*'s spouse. A decree of divorce is issued dissolving the marriage of *E* and *E*'s spouse. In anticipation of their divorce, *E* notified the plan administrator to eliminate the coverage for *E*'s spouse, and coverage for *E*'s spouse was terminated as of the last day of the month. There are no facts to indicate that *E*'s spouse would have otherwise lost coverage under the plan before the divorce. The plan administrator is provided notice of the divorce within 60 days after the issuance of the divorce decree.

LAW AND ANALYSIS

Section 4980B of the Internal Revenue Code requires certain group health plans to make continuation coverage available to certain individuals who would otherwise lose their coverage under the plan as a result of certain occurrences (the "COBRA continuation coverage requirements"). Section 4980B imposes an excise tax if a plan subject to the COBRA continuation coverage requirements fails to comply with those requirements.

Under section 4980B, the obligation of a plan to make COBRA continuation coverage available arises in connection with a qualifying event. The individuals to whom the COBRA continuation coverage must be made available are qualified beneficiaries.

Under Q&A–1 of § 54.4980B–3 of the Miscellaneous Excise Tax Regulations, an individual generally is a qualified beneficiary if the individual is covered under a group health plan on the day before a qualifying event by virtue of being on that day the spouse of a covered employee.

Under Q&A–1 of § 54.4980B–4, a divorce or legal separation of a covered employee from the covered employee's spouse is a qualifying event if, under the terms of the plan, the divorce or legal separation causes the spouse (or a dependent child of the covered employee) to lose coverage under the plan. Paragraph (c) in Q&A–1 of § 54.4980B–4 states that if coverage is eliminated in anticipation of a qualifying event, such as an employee's eliminating the coverage of the employee's spouse in anticipation of a divorce or legal separation, the elimination is disregarded in determining whether the qualifying event causes a loss of coverage.

Q&A–1 of § 54.4980B–7 states that COBRA continuation coverage must be provided for a period that begins on the date of the qualifying event. Under Q&A–1 and Q&A–4 of § 54.4980B–7, a plan generally has the obligation to make COBRA continuation coverage available to a qualified beneficiary in the case of a divorce or legal separation for 36 months after the date of the divorce or legal separation. This obligation can end earlier for a variety of reasons, such as failure to make timely payment to the plan for the qualified beneficiary's coverage.

Q&A–2 of § 54.4980B–6 provides that a group health plan is not required to offer a qualified beneficiary the opportunity to elect COBRA continuation coverage in the case of a divorce or legal separation if notice of the divorce or legal separation is not provided to the plan administrator within 60 days after the later

of the date of the divorce or legal separation or the date the qualified beneficiary would lose coverage on account of the divorce or legal separation.

E eliminated the coverage of *E*'s spouse in anticipation of their divorce. Under the regulations, this elimination is ignored in determining whether the divorce is a qualifying event. There are no facts to indicate that *E*'s spouse would have otherwise lost coverage under the plan before the divorce. Thus, if the elimination in anticipation of the divorce is ignored, *E*'s spouse would have remained covered until the divorce and then lost coverage because of it. Consequently, the divorce is a qualifying event and *E*'s former spouse is a qualified beneficiary. Because notice of the divorce was provided to the plan administrator within 60 days after the issuance of the divorce decree, the plan has an obligation to make COBRA continuation coverage available to *E*'s former spouse for a period of up to 36 months.

The period of COBRA continuation coverage begins on the date of the qualifying event. There is no authority under the statute or regulations for requiring a plan to make COBRA continuation coverage available before the date of a qualifying event. Thus, the group health plan in the facts described above has the obligation to make COBRA continuation coverage available to *E*'s former spouse effective as of the date of the divorce for a period of up to 36 months.

HOLDING

If an employee eliminates the coverage of the employee's spouse under a group health plan in anticipation of their divorce, a plan that is required to make COBRA continuation coverage available to the spouse must begin to make that coverage available as of the date of the divorce.

DRAFTING INFORMATION

The principal author of this revenue ruling is Russ Weinheimer of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Russ Weinheimer or Yurlinda Mathis at (202) 622–6080 (not a toll-free number).

Section 6018.—Estate Tax Returns

How does the estate of a "qualified decedent," as defined in section 2201(b) of the Internal Revenue Code, compute the federal estate tax under section 2201, as amended by the Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107–134, section 103, 115 Stat. 2427 (2002)? See Rev. Rul. 2002–86, page 993.

Part III. Administrative, Procedural, and Miscellaneous

Announcement of Amendments to Regulations Under Section 367 of the Internal Revenue Code

Notice 2002–77

The Internal Revenue Service (the "Service") is publishing Rev. Rul. 2002–85 contemporaneously with the issuance of this Notice. Rev. Rul. 2002–85 holds that an acquiring corporation's transfer of the target corporation's assets to a subsidiary controlled by the acquiring corporation pursuant to a plan of reorganization will not prevent a transaction that otherwise qualifies as a reorganization under section 368(a)(1)(D) from so qualifying. This notice announces that the Treasury and the Service will amend the regulations under Treas. Reg. § 1.367(a)–3(d) to provide specifically that a reorganization under section 368(a)(1)(D) followed by the transfer of all or a portion of a target corporation's assets to a controlled subsidiary pursuant to a plan of reorganization constitutes an indirect transfer of stock or securities for purposes of Treas. Reg. § 1.367(a)–3.

I. BACKGROUND

Section 367(a)(1) requires a U.S. person who transfers property (including stock or securities) to a foreign corporation in connection with an exchange described in section 332, 351, 354, 356, or 361 to recognize gain (but not loss) on the transfer, unless the transfer qualifies for an exception to this general rule. Transfers covered by section 367(a)(1) also include indirect and constructive transfers. Treas. Reg. § 1.367(a)–1T(c)(1).

Treas. Reg. § 1.367(a)–3 contains rules that address transfers of stock or securities by a U.S. person to a foreign corporation in an exchange described in section 367(a). For these purposes, certain transactions that are in form asset transfers are treated as stock transfers. For example, Treas. Reg. § 1.367(a)–3(d)(1)(v) treats as an indirect stock transfer a U.S. person's exchange of stock or securities of a corporation for voting stock or securities of a foreign acquiring corporation in a reorganization described in section 368(a)(1)(C) in which the acquiring corporation transfers the acquired corporation's assets to a subsidiary controlled by the acquiring corporation in a transaction described in section 368(a)(2)(C). In the case of a reorganization in which part but not all of the assets of the acquired corporation are transferred pursuant to section 368(a)(2)(C), the transaction is considered to be an indirect transfer of stock or securities only to the extent of the assets so transferred. Treas. Reg. § 1.367(a)–3(d)(1)(v).

In Rev. Rul. 2002–85, pursuant to a plan of reorganization, (i) a corporation (the "target corporation") transfers all of its assets to another corporation (the "acquiring corporation") in exchange for consideration consisting of 70 percent acquiring corporation voting stock and 30 percent cash, (ii) the target corporation then liquidates, distributing the acquiring corporation voting stock and cash to its shareholder, and (iii) the acquiring corporation subsequently transfers the target corporation's assets to a preexisting, wholly owned subsidiary of the acquiring corporation. Rev. Rul. 2002–85 holds that the acquiring corporation's transfer of the target corporation's assets to its controlled subsidiary as part of a plan of reorganization will not prevent a transaction that otherwise qualifies as a reorganization under section 368(a)(1)(D) from so qualifying.

II. TREATMENT OF A REORGANIZATION UNDER SECTION 368(a)(1)(D) FOLLOWED BY A TRANSFER OF THE ACQUIRED CORPORATION'S ASSETS TO A CONTROLLED SUBSIDIARY UNDER THE INDIRECT STOCK TRANSFER RULES.

Consistent with the current rules for transactions described in sections 368(a)(1)(C) and (a)(2)(C), the Treasury and the Service will amend the regulations under section 367 to provide specifically that a U.S. person's exchange of stock or securities of a corporation (the acquired corporation) for stock or securities of a foreign acquiring corporation in a reorganization under section 368(a)(1)(D) in which the foreign acquiring corporation transfers part or all of the acquired corporation's assets to a subsidiary controlled by the acquiring corporation pursuant to the plan of reorganization constitutes an indirect transfer of stock or securities by the U.S. person to the foreign acquiring corporation under Treas. Reg. § 1.367(a)–3(d). In the case of a reorganization under section 368(a)(1)(D) in which part but not all of the assets of the acquired corporation are transferred to a subsidiary controlled by the acquiring corporation pursuant to the plan of reorganization, the regulations will provide that the transaction is considered to be an indirect transfer of stock or securities to the extent of the assets so transferred. The amendment to the regulations under section 367 described in this notice will be effective for transfers occurring after **December 9, 2002**. For additional guidance concerning transfers that occurred on or after July 20, 1998 and on or before **December 9, 2002**, see Rev. Rul. 2002–85.

III. DRAFTING INFORMATION AND REQUEST FOR COMMENTS

The principal author of this notice is Richard Osborne of the Office of Associate Chief Counsel (International). However, other personnel from the Service and the Treasury participated in its development. For further information regarding this notice, contact Mr. Osborne at (202) 622–3036 (not a toll-free call).

Written comments concerning this notice may be submitted to the Associate Chief Counsel (International), Attention: Richard Osborne (Notice 2002–77), Room 4573, CC:Intl:Br4, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments directly to the IRS Internet site at *http://www.irs.ustreas.gov/prod/tax_regs/comments.html.* Comments will be available for public inspection and copying. The Treasury and the Service request comments by January 15, 2003.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 2002–75

SECTION 1. PURPOSE AND NATURE OF CHANGE

The purpose of this revenue procedure is to modify Rev. Proc. 2002–3, 2002–1 I.R.B. 117, by deleting sections 4.01(11) and

4.01(41). Sections 4.01(11) and 4.01(41) provide that the Internal Revenue Service will not ordinarily rule on the application of §§ 162 and 816 of the Internal Revenue Code to certain insurance arrangements.

SECTION 2. BACKGROUND

.01 Rev. Proc. 2002–3 sets forth those provisions of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Corporate), the Associate Chief Counsel (Financial Institutions & Products), the Associate Chief Counsel (Income Tax & Accounting), the Associate Chief Counsel (Passthroughs & Special Industries), the Associate Chief Counsel (Procedure and Administration), and Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) relating to issues on which the Internal Revenue Service will not issue letter rulings or determination letters.

.02 Section 4 of Rev. Proc. 2002–3 sets forth those areas in which rulings or determination letters will not ordinarily be issued.

Section 4.01(11) provides as follows:

Section 162.—Trade or Business Expenses.—Whether the requisite risk shifting and risk distribution necessary to constitute insurance are present for purposes of determining the deductibility under § 162 of amounts paid (premiums) by a taxpayer for insurance.

Section 4.01 (41) provides as follows:

Section 816.—Life Insurance Company Defined.—Whether the requisite risk shifting and risk distribution necessary to constitute insurance are present for purposes of determining if a company is an "insurance company" under § 1.801–3(a) of the Income Tax Regulations, unless the facts of the transaction are within the scope of Rev. Rul. 78–338, 1978–2 C.B. 107, or Rev. Rul. 77–316, 1977–2 C.B. 53.

.03 The Service has provided guidance regarding whether, for federal income tax purposes, an arrangement constitutes insurance and whether an entity that provides insurance to an insured that has an ownership interest in that entity will be treated as an insurance company. Rev. Rul. 77–316 involved an insurance subsidiary that assumed only the risks of its owners and/or affiliates and concluded that to the extent the assumed risks were not transferred outside of the economic family, the transaction would not be treated as insurance. Under the economic family theory, the amounts paid as premiums to the subsidiary would not be insurance premiums deductible under § 162 and the subsidiary would not be an insurance company. In Rev. Rul. 78–338, the Service distinguished the economic family theory advanced in Rev. Rul. 77–316 and concluded that premiums paid to an insurer owned by its 31 insureds-shareholders were deductible under § 162.

.04 Rev. Rul. 2001–31, 2001–1 C.B. 1348, announced that the economic family theory would no longer be followed, Rev. Rul. 77–316 was obsoleted, and Rev. Rul. 78–338 was modified. Rev. Rul. 2001–31 also stated that certain captive transactions may be challenged based upon the facts and circumstances of each case.

.05 Since publication of Rev. Rul. 2001–31, the Service has provided additional guidance on the tax treatment of certain captive insurance arrangements. Rev. Rul. 2002–89, 2002–52 I.R.B. 984, addressed arrangements between a parent corporation and its wholly-owned captive insurance subsidiary that conducted varying amounts of insurance business with unrelated parties. In Rev. Rul. 2002–90, 2002–52 I.R.B. 985, the Service concluded that the premiums paid by 12 operating subsidiaries to a captive insurance subsidiary owned by a common parent are deductible under § 162. Finally, in Rev. Rul. 2002–91, 2002–52 I.R.B. 991, the Service concluded that a group captive, which was formed by fewer than 31 unrelated insureds, with each insured having no more that 15% of the total risk, was an insurance company.

.06 Consistently with the case-by-case approach announced in Rev. Rul. 2001–31, and the guidance provided in Rev. Rul. 2002–89, Rev. Rul. 2002–90, and Rev. Rul. 2002–91, this Revenue Procedure deletes sections 4.01(11) and 4.01(41) of Rev. Proc. 2002–3. The Service will now consider ruling requests regarding the proper tax treatment of a captive insurance company. However, some questions arising in the context of a captive ruling request are so inherently factual (within the meaning of section 4.02(1) of Rev. Proc. 2002–3) that contact should be made with the appropriate Service function prior to the preparation of such request to determine whether the Service will issue the requested ruling. In addition, for information concerning the Large and Mid-Size Business Division Pre-Filing Agreement Program, see Rev. Proc. 2001–22, 2001–1 C.B. 745.

SECTION 3. PROCEDURE

Rev. Proc. 2002–3 is modified by deleting section 4.01(11) and section 4.01(41).

SECTION 4. INQUIRIES

Inquiries regarding whether the Service considers a proposed captive transaction so inherently factual that it cannot rule, should be directed to Chief, Branch 4, Office of the Associate Chief Counsel (Financial Institutions & Products) at (202) 622–3970 (not a toll-free call).

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–3 is modified.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective December 10, 2002.

DRAFTING INFORMATION

The principal author of this revenue procedure is William Sullivan of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Mr. Sullivan at (202) 622–3970 (not a toll-free call).

Part IV. Items of General Interest

Changes to Excise Taxes, Effective After December 31, 2002

Announcement 2002–115

The following changes are effective after December 31, 2002, and will be on Form 720 or in the Instructions for Form 720 for the 1st quarter of 2003, and on Form 8849 (Schedules 1, 3, and 4), revised January 2003.

1. The tax on sales of luxury passenger vehicles (IRS No. 92) will expire.

2. The tax on use of international air travel facilities (IRS No. 27) increases for amounts paid during 2003 to:

- $13.40 per person for flights that begin or end in the United States and
- $6.70 per person for domestic segments that begin or end in Alaska or Hawaii (applies only to departures).

3. Fuel tax changes

The following tax rates will increase:

10% gasohol (IRS No. 59)	$.132
7.7% gasohol (IRS No. 75)	.14396
5.7% gasohol (IRS No. 76)	.15436
Gasoline removed or entered for the production of 10% gasohol (IRS No. 58)	.14666
Gasoline removed or entered for the production of 7.7% gasohol (IRS No. 73)	.15596
Gasoline removed or entered for the production of 5.7% gasohol (IRS No. 74)	.16369

The gasohol blending credit rates for gasoline taxed at the full rate will decrease:

10% gasohol (CRN 356)	$.03734
7.7% gasohol (CRN 357)	.02804
5.7% gasohol (CRN 363)	.02031

The following other fuels tax rates (IRS No. 79) will increase:

Qualified ethanol	$.1315
Special motor fuels/alcohol mixture containing ethanol	.132
Diesel fuel/alcohol mixture containing ethanol	.192
Diesel fuel sold for diesel/alcohol mixture containing ethanol	.21333
Aviation fuel/alcohol mixture containing ethanol	.087
Aviation fuel sold for aviation/alcohol mixture containing ethanol	.09666

The tax rates for alcohol (ethanol) sold as but used as fuel (IRS No. 51) will decrease:

At least 190 proof	$.52
At least 190 proof and benefited from the small ethanol producer credit	.62
At least 150 proof but less than 190 proof	.3852
At least 150 proof but less than 190 proof and benefited from the small ethanol producer credit	.4852

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2002–1 through 2002–25 is in Internal Revenue Bulletin 2002–26, dated July 1, 2002.

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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2002–1 through 2002–25 is in Internal Revenue Bulletin 2002–26, dated July 1, 2002.

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