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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR APPEALS
ATTN:
FROM: Acting Associate Chief Counsel CC:FIP

SUBJECT: Premiums paid for captive insurance

This memorandum responds to your memorandum dated July 31, 2000. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =
Country A =
B =
C =
D =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
$a = $
$b = $
$c = $

ISSUE

Whether Taxpayer and its operating subsidiaries are entitled to deductions for "insurance" premiums paid to C.

CONCLUSIONS

We do not object to your recommendation that this issue be conceded as to the insurance transactions between C and the subsidiaries of Taxpayer.

FACTS

Taxpayer is engaged in the business of B. In Year 1, Taxpayer formed C, a Country A corporation, for the purpose of insuring the product liability, umbrella liability property, and comprehensive crime risks of Taxpayer and its domestic affiliates. Taxpayer owns 100 percent of the stock of C.

C also reinsured D, an unrelated corporation, for workers' compensation and employers' liability, excess workers' compensation and employers' liability, general liability and auto liability coverage issued by D to Taxpayer. C does not reinsure with unrelated parties liabilities assumed on direct policies issued to Taxpayer or on liabilities assumed by C on policies written originally by unrelated parties. C does not provide insurance coverage to any third parties outside Taxpayer's group.

On its returns for Years 2, 3, and 4, Taxpayer claimed deductions for the full amounts paid to C by Taxpayer and its domestic subsidiaries. Exam has concluded that the transactions between Taxpayer and C were not insurance for federal income tax purposes. Accordingly, Exam has proposed adjustments of $a, $b, and $c for Years 2, 3, and 4, respectively, to Taxpayer's claims for deductions.

Your discussion and analysis of the issue indicates that Taxpayer presented some evidence of a business purpose for forming the captive; Taxpayer apparently did not maintain any guarantees, indemnities, or "hold harmless" agreements to unrelated insurers or anyone else with respect to C's obligations; and, C was adequately capitalized.

Under the terms of the proposed settlement, Taxpayer would concede in full the disallowance of any premiums paid by the parent company to C, and the Service would concede in full the remainder of the premiums attributable to premiums paid by any subsidiary of the parent to C.

LAW AND ANALYSIS

Generally, premiums paid for insurance are deductible under I.R.C. § 162(a) if directly connected with the taxpayer's trade or business. Treas. Reg. § 1.162-1(a). Although the Internal Revenue Code does not define the term "insurance," the

United States Supreme Court has explained that to constitute “insurance,” a transaction must involve "risk shifting" (from the insured to the insurer) and “risk distribution” (by the insurer). Helvering v. Le Gierse, 312 U.S. 531, 539 (1941). In this regard, amounts set aside by a taxpayer as a self-insurance reserve for anticipated losses are not deductible “insurance” expenses because risk is not shifted from the taxpayer. Therefore, these amounts are not deductible until the taxpayer actually pays or accrues the anticipated loss. United States v. General Dynamics Corp., 481 U.S. 239, 243-244 (1987).

In Rev. Rul. 77-316, 1977-2 C.B. 53, three situations were presented in which a taxpayer attempted to seek insurance coverage for itself and its operating subsidiaries through the taxpayer’s wholly-owned captive insurance subsidiary. The ruling explained that the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented one “economic family” for purposes of the risk-shifting analysis. The ruling concluded that the transactions were not insurance to the extent that risk was retained within the economic family. Therefore, the premiums paid by the taxpayer and its non-insurance subsidiaries to the captive insurer were not deductible.

No court, in addressing a captive insurance transaction, has fully accepted the economic family theory set forth in Rev. Rul. 77-316. Nevertheless, each court that has addressed whether a parent corporation can deduct as insurance premiums payments made to its captive insurance subsidiary has concluded that the underlying transaction does not involve sufficient risk shifting to constitute “insurance” where the captive “insures” only its parent or the parent’s other subsidiaries. E.g., Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981); Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987).[1] In contrast, both the United States Court of Appeals for the Sixth Circuit and the United States Court of Federal Claims have held that payments to a captive insurer by its sibling subsidiary were deductible as insurance premiums. Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989); Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42 (1997).[2] The court in Humana explained that brother-sister

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[1] In Clougherty Packing, the United States Court of Appeals for the Ninth Circuit reasoned that risk had not shifted from the parent because a claims payment by the captive subsidiary reduces, dollar for dollar, the value of the insurer’s stock as reflected on the parent’s balance sheet.

[2] The courts in Humana and Kidde reasoned that, unlike parent-subsidiary transactions, sufficient risk shifting existed with respect to the brother-sister transactions because the payment of a claim with respect to a loss incurred by the insured subsidiary did not result in a diminution of the assets reflected on the insured

transactions should be considered insurance for Federal income tax purposes unless either the captive entity or the transaction is a sham. Humana, 881 F.2d at 255.

In Malone & Hyde v. Commissioner, 62 F.3d 835 (6th Cir.1995), the Sixth Circuit applied Humana to a brother-sister insurance transaction and concluded that the captive insurer was a sham, and that the payments at issue were therefore not deductible as insurance premiums. In Malone, the taxpayer and its operating subsidiaries purchased insurance from a commercial insurer, which then reinsured a significant portion of those risks with the taxpayer's captive insurance subsidiary. The commercial insurer retained a portion of premiums received from the taxpayer, and paid the remainder to the captive subsidiary as a reinsurance premium. The taxpayer claimed deductions for the insurance premiums paid to the commercial insurer. In determining that the captive insurance company was a sham corporation, the court in Malone noted that the parent "propped up" the captive by guaranteeing its performance, the captive was thinly capitalized, and the captive was loosely regulated by the locale in which the captive was incorporated (Bermuda). Id. at 840.

In addition to the factors set forth in Malone, other factors considered in determining whether a captive insurance transaction is a sham include: whether the parties that insured with the captive truly faced hazards; whether premiums charged by the captive were based on commercial rates; whether the validity of claims was established before payments were made on them; and whether the captive's business operations and assets were kept separate from its parent's. Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728-729 (1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This case presents substantial litigating hazards. The facts in this case do not present a typical captive insurance fact pattern. There appear to be no facts present during the years in issue, such as "hold harmless" agreements to unrelated insurers or anyone else with respect to the obligations of C, undercapitalization, and lack of arm's length determination of premiums, which the Service could use, at it had successfully in Malone, in arguing that either C or the underlying transactions are shams. Further, Taxpayer presented some evidence of a valid business purpose for forming the captive. There is no proof that Taxpayer made any guarantees on behalf of the captive. Finally, the Service has lost the brother/sister issue in cases such as Humana and Kidde.

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subsidiary's balance sheet when the captive insurer paid the claim.

[redacted]Therefore, we do not object to your recommendation to concede in full the brother-sister portion of this issue as a part of the settlement with Taxpayer.

Please call if you have any further questions.

Acting Associate Chief Counsel
(Financial Institutions & Products)

/S/
By:_____
MARK SMITH
Chief, CC:FIP:4