



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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

APPEALS OFFICER,

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Premiums paid for captive insurance

This Field Service Advice responds to your memorandum dated April 25, 2000. Field Service Advice 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 =
Year 1 =
B =
C =
D =
b =
\$c = \$
\$d = \$

ISSUE

Whether the Service should concede that transactions between Taxpayer's operating subsidiaries and Taxpayer's captive insurance subsidiary are "insurance" for Federal income tax purposes.

CONCLUSION

We do not object to your recommendation that this issue be conceded.

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FACTS

The year in issue is Year 1. Taxpayer is engaged in the business of B and C, and operates these activities through approximately b subsidiaries. In Year 1, Taxpayer formed a captive insurance subsidiary, D, for the purpose of insuring the property and liability risks of Taxpayer's operating subsidiaries. Although your submission does not indicate the amount of gross premiums that Taxpayer's operating subsidiaries paid to D, your submission reflects that D wrote "net premiums" in Year 1 in the amount of \$c.¹ Your submission further indicates that D reinsured with unrelated parties a portion of the risks of Taxpayer's operating subsidiaries.

D was initially capitalized in the amount of \$d, and neither Taxpayer nor its operating subsidiaries have provided indemnities or guarantees to reinsurers of D's obligations. Furthermore, D did not provide any loans to either Taxpayer or Taxpayer's affiliates.

Exam has concluded that the transactions between Taxpayer's operating subsidiaries and D are not "insurance" for Federal income tax purposes.

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

¹ We assume that the term "net premiums," as used in your submission, refers to gross premiums less premiums paid for reinsurance.

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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).² 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).³ The court in Humana explained that brother-sister 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

² 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.

³ 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 subsidiary’s balance sheet when the captive insurer paid the claim.

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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

[REDACTED]

[REDACTED]

Therefore, we do not object to your recommendation to concede this issue.

Please call if you have any further questions.

DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service)
By: JOEL E. HELKE, Chief
Financial Institutions & Products Branch