



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
NATIONAL OFFICE APPEALS

FROM: Mark Smith, Chief
Branch 4
Associate Chief Counsel (Financial Institutions & Products)

SUBJECT: Premiums paid for captive insurance

This Field Service Advice responds to your memorandum dated January 19, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

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LEGEND

Taxpayer	=
<u>X</u>	=
<u>Y</u>	=
Country A	=
Country B	=
Date 1	=
Date 2	=
\$a	= \$
\$b	= \$

ISSUES

Whether Taxpayer is entitled to deduct as “insurance” premiums amounts paid to Y pursuant to a brother-sister captive insurance arrangement?

CONCLUSIONS

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

FACTS

The years at issue are the taxable years ended Date 1 and Date 2. Taxpayer, a domestic corporation, is the wholly owned subsidiary of X, a Country A corporation. X also owns Y, a registered insurance company under the laws of Country B. Thus, Taxpayer and Y are sibling subsidiaries of a common parent.

During the taxable years ended Date 1 and Date 2, Taxpayer was putatively insured through several policies issued by Y. The risks covered by the policies included commercial general liability, products liability, and automobile liability. Taxpayer paid premiums to Y with respect to these policies in the amount of \$a during the taxable year ended Date 1, and in the amount of \$b during the taxable year ended Date 2. For federal income tax purposes, Taxpayer claimed deductions for the amounts that it paid to Y.

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

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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 has fully accepted the economic family theory as set forth in Rev. Rul. 77-316. Particularly, 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). In both Humana and Kidde, the captive in question insured risks only within its related group. Both courts reasoned that sufficient risk shifting existed with respect to the brother-sister transactions because a loss incurred by the insured subsidiary did not diminish the assets reflected on that subsidiary’s balance sheet when the captive paid claims. 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 itself 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

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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, that the captive was thinly capitalized, and that 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 possible factors to consider 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:

All of the premiums at issue are attributable to brother-sister captive insurance transactions. Given the opinions in Humana and Kidde, it is unlikely that a court in this case would invalidate these transactions on the basis of the economic family theory set forth in Rev. Rul. 77-316. Your submission further indicates that there are no relevant distinctions between the facts in this case and the facts set forth in Humana.



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

Please call if you have any further questions.

Lon B. Smith
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(Financial Institutions and Products)
By: MARK SMITH, CHIEF
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