OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR APPEALS
ATTN:

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Premiums paid for captive insurance

This Field Service Advice responds to your memorandum dated January 20, 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.

<u>LEGEND</u>

Taxpayer =
Country A =
B =
C =
D =
E =
F =
G =
H =
J =
K =
Year 1 =
Year 2 =
$a = $
$b = $
$c = $
$d = $
e% = %

ISSUE

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

CONCLUSIONS

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

FACTS

Taxpayer is engaged in the business of B. In Year 1, Taxpayer had over C subsidiaries with over D employees. The stock of Taxpayer is primarily owned by E trusts, of which F and G are the lifetime beneficiaries. The remaindermen of the trusts are F's and G's children.

In Year 1, Taxpayer formed H, a Country A corporation, for the purpose of insuring the worker's compensation, general liability, and automobile liability risks of Taxpayer and its operating subsidiaries. Taxpayer did not own any stock in H, however; nearly all of H's stock was owned by the remaindermen of the trusts which owned Taxpayer. Likewise, F and G, the current beneficiaries of the trusts, did not own any shares in H. H's shareholders made an initial capital contribution in the amount of $a, and obtained a letter of credit for H's benefit in the amount of $b.

For Years 1 and 2, H provided coverage to Taxpayer and its operating subsidiaries for the first $c of each workers' compensation loss occurrence, and for the first $d of each general liability and automobile liability occurrence. A portion of Taxpayer's workers' compensation and general liability risks were directly insured by J, an unrelated commercial insurer, which then reinsured the risks with H. H's board of directors hired K, an unrelated company, to provide brokerage and management services. The premiums paid by Taxpayer to H were determined by an actuarial analysis of the underlying risks, based both upon industry data and Taxpayer's specific loss history. The premiums, net of expenses such as taxes and administrative costs, were set at an amount to pay for losses at an e% level, i.e., there was an e% chance that losses would exceed the forecast level.

On its returns for Years 1 and 2, Taxpayer claimed deductions for the full amounts paid to H and J. Exam has concluded that the transactions between Taxpayer and H were not insurance for federal income tax purposes. Exam further concluded that the transactions between Taxpayer and J were not insurance to the extent that the risks of Taxpayer and its operating subsidiaries were reinsured by H. Accordingly, Exam has disallowed Taxpayer's claims for deductions with respect to all of the amounts paid by Taxpayer to H, and with respect to a portion of the amounts paid by Taxpayer to J.

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

[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.

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 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

[redacted] First, the facts in this case do not present a typical captive insurance fact pattern. H is not owned by any of the entities that it insures, i.e., Taxpayer and Taxpayer's operating

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

subsidiaries. Rather, H is owned by the remaindermen of several trusts that own Taxpayer. Losses of Taxpayer that are paid by H, therefore, do not diminish the assets reflected on Taxpayer's balance sheet. Accordingly, the Service cannot rely upon the reasoning set forth in Clougherty Packing in an attempt to argue that the ownership relationship between H and Taxpayer precludes H from insuring Taxpayer. Furthermore, there appear to be no facts present during the years in issue, such as indemnification agreements propping up H, 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 H or the underlying transactions are shams.[3]

[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
By: JOEL E. HELKE
Chief
CC:DOM:FS:FI&P

[3] We understand that Exam has argued that the premiums charged by H were not determined at arm's length. In doing so, Exam contends that because the premiums charged were calculated so that H would break even and only generate profits from investing, the premiums were not established at arm's length. This factor, standing alone, is not sufficient to conclude that the premiums charged by H were less than arm's length. In this regard, the Insurance Services Office and the National Association of Independent Insurers has published data indicating that the property and casualty insurance industry as a whole generated net underwriting losses in the amount of $23.3 billion in 1999 and $16.7 billion in 1998, and generated net operating income only through investment income and capital gains. National Underwriter, Property & Casualty/Risk and Benefits Management Edition, April 10, 2000, at 1.