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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

This memorandum responds to your memorandum dated November 6, 2000, concerning the proposed concession of an issue involving captive insurance. 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 A =
Taxpayer B =
C =
City D =
Country E =
Number F =
Number G =
Number H =
Number I =
Number J =
K =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Date 1 =
Date 2 =
Date 3 =
Date 4

L =
Country M =

ISSUE

Whether Taxpayers A and B and their operating subsidiaries are entitled to deductions for "insurance" premiums paid to L.

CONCLUSIONS

We do not object to your recommendation that this issue be conceded as to the insurance transactions between L and Taxpayers A and B.

FACTS

Taxpayer B is a wholly-owned subsidiary of C of City D, a Country E corporation. C is the ultimate parent of approximately Number F subsidiaries, about Number G of these are non-United States corporations. The operating subsidiaries of Taxpayer B are primarily engaged in K businesses. Taxpayer B filed a consolidated federal income tax return as the common parent of the United States affiliated group for calendar years Year 2, Year 3 and Year 4. Prior to Year 2, Taxpayer A was the United States holding company of the United States group.

On Date 1, C formed L, a wholly-owned insurance company incorporated under the laws of Country M and licensed under the laws of Country M to issue all classes of property and casualty insurance. C has contributed substantial capital to L. In its present form, L is a brother-sister corporation of Taxpayer B.

L issued four types of insurance coverage: Global Material Damage/Business Interruption, Global Public/Product Liability, Workers' Compensation and Employer's Liability. Beginning on Date 2, L participated in the Workers' Compensation risks of Taxpayers A and B and, on Date 3, L expanded its participation. This business was completely reinsured until Date 4 when the coverage ceased, with L accepting all outstanding and future liabilities arising from the period from Date 2 to Date 4. This insurance covered over Number H companies with over Number I employees.

During the tax years Year 1 through Year 4, L reinsured selected risks of C and its subsidiaries through the issuance of Global Material Damage/Business Interruption insurance covering over Number F companies; Global Public/Product Liability insurance covering over Number F companies; and Employer's Liability insurance in Country E covering over Number H corporations consisting of approximately Number J employees.

On its returns for Year 1, Taxpayer A and, for Years 2, 3, and 4, Taxpayer B, claimed deductions for the full Numbers paid to L by Taxpayers A and B and their domestic subsidiaries. Exam has concluded that the transactions between Taxpayers A and B, and L were not insurance for federal income tax purposes. Accordingly, Exam has proposed adjustments denying Taxpayers' claims for deductions for amounts paid as premiums.

Your discussion and analysis of the issue indicates that Taxpayers A and B presented some evidence of a business purpose for forming the captive. Furthermore, there were no parental guarantees, comfort letters or letters of credit issued by L, or by Taxpayer A or B on L's behalf. L was adequately capitalized. There is no representation that either Taxpayer A or Taxpayer B made any guarantees on behalf of L.

Under the terms of the proposed settlement, the Service would concede in full the Numbers attributable to premiums paid to by Taxpayer A to L in Year 1; and premiums paid by Taxpayer B to L in Year 2, Year 3, and Year 4.

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, Numbers 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 Numbers are not deductible until the taxpayer actually pays or accrues the anticipated loss. United States v. General Dynamics Corp., 481 U.S. 239, 243-44 (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. See, 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 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).

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

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 L, undercapitalization, and lack of arm's length determination of premiums, which the Service could use, as it had successfully in Malone, in arguing that either L 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.

Accordingly, we agree with your conclusion that, given the facts in this case, the Service is unlikely to prevail on this issue. Therefore, we do not object to your recommendation to concede in full the amounts in question as a part of the settlement with Taxpayer.

Please call if you have any further questions.

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