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

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Premiums paid for captive insurance coverage

This Field Service Advice responds to your memorandum dated February 26, 1999. 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 =
B =
C =
D =
E =
F =
G =
H =
J =
K =
State L =
Year 1 =
Year 3 =
Year 4 =
Year 5 =

Date 1	=
b	=
$c	= $
$d	= $
$e	= $
$f	= $
$g	= $
$h	= $
$i	= $
$j	= $
$k	= $
$l	= $
$m	= $
$n	= $
p%	= %
q%	= %
r%	= %
s%	= %

ISSUE:

Whether amounts paid by Taxpayer's operating subsidiaries to Taxpayer's captive insurance subsidiary are deductible under I.R.C. § 162 as insurance premiums.

CONCLUSION:

We suggest further factual development, as set forth, infra.

FACTS:

B, an organization presently granted tax exempt status under IRC § 501(c)(3), exists for the primary purpose of operating and maintaining C in State L. Nevertheless, B carries on significant business operations and investments through numerous subsidiaries. In Year 1, to avoid being taxed on its unrelated business income, B formed Taxpayer, B's wholly-owned holding company.

On Date 1, Year 3, Taxpayer formed D, a captive insurance subsidiary. B approved Taxpayer's formation of D for the purpose of providing worker's compensation, general liability, property, and automobile insurance for B and its subsidiaries. Taxpayer acquired b shares of D's one dollar par stock in exchange for a capital contribution of $c. Taxpayer and its subsidiaries, including D, file a consolidated return.[1]

After its formation, D issued the following four insurance policies, each covering B, Taxpayer, and their affiliated companies: (1) a property insurance policy, subject to a $d deductible, covering a maximum of $e per occurrence; (2) a retrospectively-rated worker's compensation policy covering a maximum of $f per accident; (3) a comprehensive automobile policy covering a maximum of $g per accident or loss; and (4) a general liability covering a maximum of $f per occurrence. D charged premiums on the basis of a risk exposure analysis performed with respect to each entity covered by the policies. The policies reflect the amount of premium attributable to each covered entity, and D billed each entity accordingly.

It is our understanding that D has reinsured through H its liabilities under the policies to the extent that losses resulting from any occurrence exceed $h. B also purchased excess liability and umbrella policies for losses in excess of the coverage limits reflected in the policies issued by D.

D is managed by a three member board of directors comprised of a current trustee of B, a former trustee of B, and B's manager. B provided clerical assistance to D, and compensated persons providing services to D. Upon formation of D, J became B's risk management broker and K, who had been B's risk manager, became D's president. J entered into an insurance management agreement with B in Year 3. D paid management fees to J in the amounts $i in Year 4 and $j in Year 5; D, however, has no employees. The amounts paid by D to J were deducted on Taxpayer's consolidated return.

Neither B nor Taxpayer have entered into guaranty or indemnification agreements to ensure D's performance under the "insurance" agreements. Moreover, D's premium to surplus ratio is within reasonable bounds, and Taxpayer did not borrow from the D's surplus.

The total premiums earned by D in Year 4 and Year 5 were $k and $l, respectively. Of those amounts, p% and q% appear to be attributable to B's or Taxpayer's other taxable subsidiaries. Premiums received from unrelated third parties totaled r% and s% for Year 4 and Year 5, respectively. The examining agent proposes to disallow deductions for premiums in the amount of $m in Year 4 and $n in Year 5. These are the premiums paid to D by its sibling subsidiaries.

<u>LAW AND ANALYSIS</u>

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[1] In addition to D, Taxpayer wholly owns E, F, and G.

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 insurance expenses because risk is not shifted from the taxpayer; therefore, such 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 instances where the taxpayer enters into an "insurance" arrangement with a related "insurance" company, both the Service and the courts have attempted to address whether sufficient risk shifting is present in order for the transaction to be considered insurance. In Rev. Rul. 77-316, the Service addressed three situations whereby a taxpayer attempted to seek insurance coverage for itself and its operating subsidiaries through the taxpayer's wholly-owned captive insurance subsidiary. The Service concluded that the transactions were not insurance to the extent that risk was retained by the captive insurance subsidiary. The Service reasoned that the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary, represented one "economic family" for purposes of the risk shifting analysis. Consequently, although risk shifted among separate entities within the economic family, the transaction did not result in sufficient risk shifting to constitute "insurance" because the economic burden of losses remained within that family. Therefore, the premiums paid by the taxpayer and its non-insurance subsidiaries were not deductible.

Courts have uniformly held that transactions between a parent and its captive insurance subsidiary do not constitute "insurance" where the captive "insures" only entities to which it is related. E.g., Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985); Carnation Company v. Commissioner, 640 F.2d 1010 (9th Cir. 1981), affg. 71 T.C. 400 (1978); Mobil Oil Corp. v. United States, 8 Cl.Ct. 555 (1985). Nevertheless, no court so holding has totally accepted the economic family theory as set forth in Rev. Rul. 77-316. Although some of the earlier cases involving parent-subsidiary transactions appear to endorse the essence of the economic family theory, those cases do not expressly rely upon the theory due to apprehension that it will be invoked outside of the context of captive insurance and run afoul of the doctrine of separate corporate existence set forth in Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 439 (1943).[2] See AMERCO, Inc. v.

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[2] In Moline Properties, the Court held that, absent an exception, e.g., where the corporation is a sham, a corporation should be viewed as a separate taxable entity.

Commissioner, 979 F.2d 162, 166 (9th Cir. 1992) (explaining reluctance of courts to accept the economic family theory). In Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), the Ninth Circuit attempted to reconcile its refusal to characterize a parent-subsidiary transaction as insurance with Moline Properties by fashioning the "balance sheet test." Under this approach, the court in Clougherty Packing reasoned that a parent-subsidiary transaction is not insurance because a loss covered by the captive subsidiary will reduce, dollar for dollar, the value of the insurer's stock reflected on the parent's balance sheet. The court reasoned that such an approach is consistent with Moline Properties because the parent's assets are viewed apart from the captive insurance subsidiary's assets. Clougherty Packing, 811 F.2d at 305.

Employing the balance sheet test set forth in Clougherty Packing, 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, unlike parent-subsidiary transactions, 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 the claim. Relying upon Moline Properties, each court 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; Kidde, 40 Fed.Cl. at 47.

In Malone & Hyde v. Commissioner, 62 F.3d 835 (6th Cir.1995), the Sixth Circuit in applying the above analysis to a brother-sister insurance transaction concluded that the arrangement was a sham and thus held that the payments were not deductible as insurance premiums under section 162(a). In determining that the captive insurance company was a sham corporation, the court noted that the parent propped up the captive by agreeing to indemnify the insureds for any losses which the captive was unable to pay, the captive was thinly capitalized, and the captive was loosely regulated by the locale in which the captive was incorporated (Bermuda). Id. at 840. 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

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Accordingly, in contexts other than insurance, such as sales, leases, or loans, both the Service and the courts have recognized for tax purposes the validity of transactions between related entities if the essential elements of the transaction are present and the entities acted at arm's length.

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]

As reflected by the Sixth Circuit's opinion in Malone, the question of whether a transaction is insurance is not solely determined by the economic family theory. Brother-sister transactions will be subject to the same standards as those applied to unrelated parties who enter into purported "insurance" transactions. E.g., LeGierse, supra (holding that transaction between unrelated parties did not transfer sufficient risk to constitute insurance); Steere Tank Lines, Inc. v. Commissioner, 577 F.2d 279 (5th Cir. 1978) (holding that taxpayer deposited a self-insurance reserve with unrelated party, and did not enter into an insurance contract). Accordingly, we encourage you to develop the following additional facts which will address whether the transactions at issue are insurance:

1. Your submission reflects that insurance was readily available to B, Taxpayer, and their affiliated entities prior to the formation of the captive. The Taxpayer's business purpose in establishing the captive is not clear. What are the non-tax business reasons behind the creation of this captive, e.g., did liability insurance become too expensive? In this regard, request the taxpayer to provide any feasibility or cost studies, internal memoranda, and correspondences relating to its decision to establish the captive; the manner in which premiums were determined; and the manner in which loss reserves were established. We note that in Humana, the court viewed as favorable to the taxpayer the fact that the taxpayer's commercial insurer canceled coverage and the taxpayer was forced to form a captive insurer.

2. Obtain copies of D's financial statements. Did D maintain books and records comparable to other insurers? Specifically, did D properly record its incurred net losses reflecting claims accrued at the beginning and end of each year, claims paid during each year, and losses incurred for each year? Did D maintain claims files in support of the incurred losses?

3. Did D utilize recognized loss prevention programs, including product safety and quality control programs?

4. Obtain copies of the risk management agreements between B, Taxpayer, and J.

5. Request that D submit a schedule of all retrospective premium adjustments with respect to the worker's compensation policy.

[redacted]

[redacted] Lastly, we note that your submission indicates that the Service may attempt to disregard Taxpayer as a sham entity. This would not affect our conclusions in this case. Were Taxpayer to be disregarded, the transactions at issue would still constitute a brother-sister captive arrangement; B, rather than Taxpayer, would be the common parent.

If you have any further questions, please call (202) 622-7870.

Deborah A. Butler
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By: ______________________________
JOEL E. HELKE
Branch Chief
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cc: