



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

OFFICE OF
CHIEF COUNSEL

June 12, 2000

Number: **200043011**
Release Date: 10/27/2000
CC:DOM:FS:FI&P
WTA-N-107454-00
UILC: 162.04-03

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 February 14, 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 =
- Country A =
- Country B =
- Date 1 =
- Date 2 =
- Date 3 =
- Year 1 =
- Year 8 =
- Year 9 =
- Year 10 =
- B =
- C =
- D =
- E =
- F =
- G =
- \$a = \$
- \$b = \$
- \$c = \$

WTA-N-107454-00

\$d = \$
 \$e = \$
 \$f = \$
 \$g = \$
 \$h = \$
 j% = %

ISSUES

1. Whether the Service should concede that the transactions at issue are “insurance” for Federal income tax purposes; and
2. Whether the Service should concede that Taxpayer’s captive insurance company, F, qualifies as an insurance company for the year in issue.

CONCLUSIONS

We do not object to your recommendation that the two issues mentioned above be conceded.

FACTS

The year in issue is Year 8. Taxpayer and its operating subsidiaries are in the business of providing B services. Prior to Date 1, Year 8, Taxpayer’s predecessor corporation, C, was a domestic holding company which conducted the U.S. operations of D, its parent company incorporated in Country A. On Date 1, Year 8, D sold C; as part of the sale, C’s purchasers consolidated C with several of its subsidiaries and reorganized the new entity as Taxpayer. From Year 1 until the date of the sale, C and its operating subsidiaries insured their professional liability risks through unrelated commercial insurers, which then reinsured a portion of the risks with E, D’s wholly owned insurance subsidiary incorporated in Country A. These contracts provided coverage on a “claims-made” basis.

Transaction #1: The Quota Share Reinsurance Agreement

Pursuant to the sale, Taxpayer agreed to form a new captive insurance subsidiary, F, for the purpose of insuring C’s pending professional liability claims that E was insuring at that time. F is a Country B corporation organized on Date 2, Year 8. F entered into a quota share reinsurance transaction with E, whereby E transferred to F all of the liability associated with C’s pending professional liability claims. F was required under the quota share agreement to set aside in an offshore trust \$a with respect to one particular claim. To the extent that \$a was not used to pay that

WTA-N-107454-00

specific claim, F was required to refund to E the lesser of j% of such remainder, or \$b. F was also required under the agreement to set aside \$c as security for “loss development protection.” F paid a portion of this amount, \$d, to a commercial insurer, G, as a premium for coverage for excess loss development for claims arising under the quota share reinsurance agreement. Specifically, G agreed to provide coverage to F to the extent that F’s ultimate net losses exceeded \$e, at maximum amounts of \$f per claim and \$g for aggregate claims.

On its consolidated return for Year 8, Taxpayer treated the projected net profit from the quota share reinsurance agreement as “other income,” followed by a capital contribution to F in the same amount. Taxpayer calculated this amount as follows:

Gross premium per quota share reinsurance agreement
 Less: Commission
 Less: Projected refund to E
 Less: Nominal reserves established for covered claims
Less: Amount (\$d) paid to G

Projected net profit from transaction

F, in turn, reflected net written premium on the consolidated return in an amount equal to the nominal reserves that had been established for covered claims. F calculated this amount as follows:

Gross premium per quota share reinsurance agreement
 Less: Commission
 Less: Projected refund to E
 Less: Projected net profit from transaction reported by Taxpayer
Less: Amount (\$d) paid to G

Net written premium per return

F reduced its net written premiums reported by the amount of its discounted unpaid losses.

Transaction #2: Reinsurance agreement between F and G

Your submission also indicates that after C was sold, Taxpayer insured the professional liability risks of itself and its operating subsidiaries with G with respect to claims arising from Date 3, Year 8 to Date 3, Year 9. G then reinsured all of its liabilities arising from this agreement with F, and ceded to F the premiums initially paid by Taxpayer. F then entered into three retrocession agreements with

WTA-N-107454-00

unrelated companies whereby F effectively obtained coverage to the extent that aggregate claims from the professional liability policy exceeded \$e, but were no greater than \$h.

F reported the transaction on the consolidated return as follows:

Gross premium ceded from G
 Less: Amounts paid for three retrocession agreements
 Less: Unearned portion of premium after 20% haircut
 Net premium earned from reinsurance agreement

The only entities insured by F during Year 8 were either Taxpayer or Taxpayer's operating subsidiaries.

LAW AND ANALYSIS

Exam has concluded that neither the quota share reinsurance agreement (Transaction #1) nor the reinsurance transaction between F and G (Transaction #2) constitute "insurance." Accordingly, Exam has concluded that Taxpayer is not entitled to deduct amounts paid to F, and that F is not taxable as an insurance company for the year in issue.

1. Whether the transactions in issue are "insurance"

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

WTA-N-107454-00

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 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

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.

WTA-N-107454-00

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).

2. Whether F is taxable as an insurance company

Insurance companies other than life insurance companies are taxed under § 831. Section 831 does not specifically define what constitutes an insurance company. Section 1.831-3(a) of the regulations, however, states that for purposes of §§ 831 and 832, the term “insurance companies” means only those companies which qualify as insurance companies under former § 1.801-1(b) of the regulations (the successor regulation to former § 1.801-1(b) is now § 1.801-3(a)(1)).

Section 1.801-3(a)(1) of the regulations provides:

The term “insurance company” means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

In Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497 (1971), aff’d. per curiam, 469 F.2d 697 (9th Cir. 1972), the Tax Court addressed whether the taxpayer was taxable as an insurance company by comparing the taxpayer’s insurance-related and non insurance-related income. In that case, the taxpayer’s shareholders formed the taxpayer for the ostensible purpose of reinsuring life insurance risks, and contributed to the taxpayer cash and other assets. During the

WTA-N-107454-00

“insurance” coverage for events which have already occurred give rise to the issue as to whether the transaction involves the transfer of insurance risk.

In Rev. Rul. 89-96, 1989-2 C.B. 114, the Service presented a situation where a taxpayer attempts to purchase insurance coverage from an unrelated party for an event which had already occurred. In that ruling, a party (P) incurred a substantial liability due to a catastrophe. P did not know the exact amount of its liabilities, but it was expected to be in excess of \$130x. P's insurance coverage at the time of the catastrophe totaled \$30x. One month after the catastrophe, P purchased additional "liability insurance" coverage from an unrelated insurer (UI), in the amount of \$100x. P paid UI a premium in the amount of \$50x. Under the contract, UI promised to pay up to \$100x of P's liabilities in excess of P's primary coverage of \$30x. The issue presented is whether the arrangement between P and UI constituted insurance for purposes of determining UI's federal income tax liability.

The Service concludes in the ruling that the arrangement is not insurance, and UI was not permitted to increase its losses incurred deduction by the losses ceded pursuant to the agreement. The Service emphasizes that UI accepted risks under the contract with respect to events which had already occurred. UI accepted an investment risk because it hoped that the \$50x premium it had received, coupled with the tax savings from a "losses incurred" deduction, could be invested and increased into an amount which would exceed its \$100x maximum liability. Thus, the risk transferred related to investment and timing risk, but not insurance risk. Consequently, UI was not permitted a deduction for additions to unpaid loss reserves relating to the contract.

Transaction #1 is similar to the situation set forth in Rev. Rul. 89-96 insofar as E and F were aware of all the claims covered under the agreement at the time that it was entered.



WTA-N-107454-00

Given the substantial litigation hazards present in arguing that the transactions were not insurance, there are equally substantial hazards in arguing the F was not taxable as an insurance company for Year 8.

Further factual development, as described, could change our analysis as to whether the Service should concede this case. We would not oppose your decision to send this case back to Exam for such development.

In sum, we agree with your conclusion that, given the facts in this case, the Service is unlikely to prevail on regarding the main issues set forth in your submission. Therefore, we do not object to your recommendation to concede those issues.

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