Section 118.—Contributions to the Capital of a Corporation

26 CFR 1.118–1: Contributions to the capital of a corporation.

The revenue ruling obsoletes Rev. Rul. 77–316 (1977–2 C.B. 53), which provided that payments between related parties that were disallowed as deductions for insurance premiums should be recharacterized as contributions to capital under I.R.C. § 118. See Rev. Rul. 2001–31, on this page.

Section 162.—Trade or Business Expenses

26 CFR 1.162–1: Business expenses.

The revenue ruling announces that the Service will not raise the economic family theory, originally set forth in Rev. Rul. 77–316 (1977–2 C.B. 53), in determining whether payments between related parties are deductible insurance premiums. See Rev. Rul. 2001–31, on this page.

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26 CFR 1.162–1: Business expenses.
(Also §§ 118, 165, 301, 801, 831; 1.118–1, 1.165–1, 1.301–1, 1.801–3, 1.831–3.)

This ruling explains that the Service will no longer raise the "economic family theory" set forth in Rev. Rul. 77–316 (1977–2 C.B. 53), in addressing whether captive insurance transactions constitute valid insurance. Rather, the Service will address captive insurance transactions on a case-by-case basis.

Rev. Rul. 2001–31

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 analyzing whether transactions involved sufficient risk shifting and risk distribution to constitute insurance for federal income tax purposes. *See Helvering v. Le Gierse*, 312 U.S. 531 (1941). The ruling concluded that the transactions were not insurance to the extent that risk was retained within that 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. *See, e.g., Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989); *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987) (employing a balance sheet test, rather than the economic family theory, to conclude that transaction between parent and subsidiary was not insurance); *Kidde Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997). Accordingly, the Internal Revenue Service will no longer invoke the economic family theory with respect to captive insurance transactions.

The Service may, however, continue to challenge certain captive insurance transactions based on the facts and circumstances of each case. *See, e.g., Malone & Hyde v. Commissioner*, 62 F.3d 835 (6th Cir. 1995) (concluding that brother-sister transactions were not insurance because the taxpayer guaranteed the captive's performance and the captive was thinly capitalized and loosely regulated); *Clougherty Packing Co. v. Commissioner* (concluding that a transaction between parent and subsidiary was not insurance).

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 77–316, 1977–2 C.B. 53; Rev. Rul. 78–277, 1978–2 C.B. 268; Rev. Rul. 88–72, 1988–2 C.B. 31; and Rev. Rul. 89–61, 1989–1 C.B. 75, are obsoleted.

Rev. Rul. 78–338, 1978–2 C.B. 107; Rev. Rul. 80–120, 1980–1 C.B. 41; Rev. Rul. 92–93, 1992–2 C.B. 45; and Rev. Proc. 2000–3, 2000–1 I.R.B. 103, are modified.

DRAFTING INFORMATION

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