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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 APPEALS
ATTN:

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

SUBJECT: Premiums paid for captive insurance

This Field Service Advice responds to your memorandum dated December 2, 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 =
C =
D =
E =
F =
G =
H =
State A =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
$a = $
$b = $
$c = $

ISSUE:

Whether Taxpayer's operating subsidiaries are entitled to deductions for "insurance" premiums paid to C pursuant to a brother-sister captive insurance arrangement.

CONCLUSION:

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

FACTS:

The taxable years in issue are Years 2 though 4. In Year 1, Taxpayer formed C in State A for the purpose of insuring the property risks of Taxpayer and Taxpayer's operating subsidiaries. Among Taxpayer's operating subsidiaries are D, E, and F. During Years 2 through 4, C provided the following direct insurance coverage to its sibling subsidiaries: Federal Employers Liability Act (FELA) liability, general liability, automobile liability, workers' compensation, Longshore & Harbor Workers' Compensation Act (LHWCA) liability, property insurance, and marine liability.[1] In addition, C reinsured risks of its sibling subsidiaries which were directly insured by G, an unrelated commercial insurance company. Most of the risks insured by C concern the workers' compensation and FELA liabilities of D, E, and F.

In Year 2, the Insurance Department for State A required that C's capitalization be increased in light of the large direct liability coverage that C was writing. Accordingly, for Years 2 and 3, C's paid-in capital totaled $a, including a letter of credit from Taxpayer in the amount of $b. During Year 4, Taxpayer withdrew the letter of credit, thereby reducing C's paid-in capital to $c.

Other than officers paid by its sibling subsidiaries, C had no employees during Years 2 and 3, and relied upon a management firm, H, and Taxpayer's corporate accounting department to prepare its financial statements. In Year 4, however, C employed a president, general manager, and financial manager for the purpose managing its activities and preparing its own financial statements. For each of the years in issue, C relied upon H to assist it in meeting the requirements of State A; to provide a resident of State A to act as a member of C's Board of Directors; to

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[1] FELA is set forth at 45 U.S.C. § 51 et seq. (1994 ed.), and pertains to common carriers by railroad, and LHWCA is set forth at 33 U.S.C. § 901 et seq. (1994 ed.), and pertains to parties employing individuals engaged in maritime employment in the navigable waters of the United States.

provide advice on captive insurance industry customs, practice, and technical matters; and to provide other administrative assistance in implementing C's insurance and reinsurance programs. H and an outside actuarial firm, relying upon loss development factors and industry data, assisted C in determining the premiums that C charged and in calculating C's reserves.

Exam has concluded that the transactions between C and its sibling subsidiaries were not insurance for federal income tax purposes. Accordingly, Exam has disallowed the sibling subsidiaries' claims for deductions with respect to the amounts paid to C for Years 2 through 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, 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 has fully accepted the economic family theory as set forth in Rev. Rul. 77-316. Particularly, 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 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 claims. 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 itself 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]

[redacted] Therefore, we do not object to your recommendation to concede this issue.

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

DEBORAH BUTLER
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By: _____
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