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FEDERAL INCOME TAXATION AND CAPTIVE INSURANCE

William B. Barker*

I. INTRODUCTION

Recent decisions from the U.S. Claims Court, U.S. District Courts, U.S. Tax Court, and the Ninth and Tenth Circuits have held that insurance premiums paid by a corporation and its affiliates to a wholly- or partially-owned insurance affiliate do not constitute deductible insurance premiums for federal income tax purposes.¹ In reaching their decisions, these courts have uniformly found that captive insurance does not satisfy the federal tax definition of insurance. They have, however, neither denied the separate legal status of the insurance affiliates nor questioned the doctrine of separate corporate entities.

These decisions present two central issues. First, according to these decisions, a contract of insurance between a corporation and its affiliate that satisfies the private law category of insurance does not qualify as insurance for federal tax purposes.² The rationale for

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² See, e.g., Mobil, 8 Cl. Ct. at 567.
this conclusion is that insurance for federal tax purposes requires the transfer of the risk of loss from one party to another, and a corporation, in reality, does not shift the risk of loss to its affiliate. This theory is based on the well-recognized substance over form and sham transaction doctrines. These doctrines evolved in an attempt by tax administrators and courts to cure what was perceived to be abusive tax avoidance. These doctrines, however, create a serious problem for practitioners seeking to distinguish between legitimate and illegitimate forms of tax avoidance.

Therefore, simple reliance on these doctrines is inappropriate.

The second central issue of the captive insurance decisions is the extent of their application to different fact situations. Taxpayers obviously need to know whether variations in ownership of the captive insurer or in the nature of the business of the captive insurer could produce a different result.

To evaluate the tax treatment of captive insurance transactions as represented by the recent cases, one should examine the courts’ reliance on the disciplines of economics, insurance, and accounting and analyze the relevance of these disciplines to proper tax treatment. Specifically, one must understand the business and tax reasons for the widespread use of captive insurance. Moreover, one must examine the theory of insurance that underlies the courts’ decisions: Is risk transfer always required? Furthermore, one must consider the effect of basic tax doctrines, such as the substance over form and separate corporate entity doctrines, on the question of the validity of captive insurance. A related concern is whether different factual scenarios, such as when third parties are involved in a captive insurance relationship, should cause a different tax result. On one level, the answer to this question depends on the sys-

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3 Id.

4 This activist role of the courts has been rationalized by one author who is highly critical of the doctrine: “We must first remember that justification for preventing tax avoidance is rational and legitimate: the need for protection of the federal revenues by preservation of public confidence in our system of taxation.” Rice, Judicial Techniques in Combating Tax Avoidance, 51 Mich. L. Rev. 1021, 1051 (1953).

5 As noted by one author: “In spite of all that has been written about the business purpose doctrine, sham transactions, net effect, and the role of the court in looking through form to find substance, no authoritative, explicit rationale for judicial intervention to frustrate plans for tax avoidance has ever been given.” Fuller, Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation, 37 Tul. L. Rev. 355, 389 (1963).
tematic treatment of the theory underlying the courts' view of risk transfer and risk distribution. On a different level, however, this underlying theory may be limited in its scope by tax administrators or courts based on a view that factual variants may eliminate abusive tax avoidance. Finally, one must understand the Code-based alternatives to dealing with the captive insurance issue. The remainder of this article will address and analyze each of these points in order better to understand the central issues of the recent captive insurance cases.

II. OVERVIEW OF CAPTIVE INSURANCE

A. Defining the Captive Insurer

Though the terms captive insurer and captive insurance are well-recognized terms of art, no court has yet attempted to define these terms specifically, probably because the issue has been universally framed in terms of whether transactions actually constitute insurance. A definition is useful, however, in understanding the nature of the transactions and the possible scope of this issue.

A captive insurer is usually defined in the insurance literature as "a wholly-owned insurance subsidiary with a primary function of insuring the outstanding exposures of the parent organization." This definition is satisfactory as long as one understands that a captive insurer may be partially owned and that the term "parent organization" also includes subsidiaries and affiliates of the captive's direct owner.

One commentator offers a more comprehensive definition: "[t]he captive might be generally defined either as an insured controlled carrier or as a carrier owned by interests owning or controlling the risks insured therein." This definition (1) expresses the crucial notion of a business enterprise insuring its pure or insurable risks through an insurance company that it controls through an ownership position and (2) allows for the situation where individuals A and B together own corporations X and Y, and X insures its risks with Y. The idea of control can be very broad, but as a tax matter

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\(^6\) Reiss, Captive Insurance Companies, Nat'l Ins. Buyer, July 1960, at 8; see also 1 C. Williams, G. Head & R. Horn, Principles of Risk Management and Insurance, 139 (2d ed. 1981) [hereinafter C. Williams].

\(^7\) Goshay, Captive Insurance Companies, in Risk Management 84 (H. Snyder ed. 1964).
it is important that the insured, either directly or indirectly, has a financial ownership interest in the captive insurer. The concept of control does add an important element to the definition, however, for the concept helps distinguish a captive insurer from a mutual insurance company. In a mutual insurance arrangement, the insured owner’s control is practically nonexistent.

B. Concepts in Business Risk Theory: Why Captive Insurance?

In order to understand fully the tax treatment of captive insurance, it is important to understand the larger role of the captive insurer in the overall business context. Individuals and businesses face hazards which expose them to adverse but uncertain financial consequences. These are known as pure risks or insurable risks. A business’s reaction to these risks is known as the discipline of risk management. Other than loss control, which is the attempt by the business enterprise to minimize the potential for adverse potential losses, the business enterprise faces a decision between two basic alternatives: either to retain the financial consequences of the loss exposure or to transfer the financial consequences of the loss exposure to another. Retention is known as self-insurance or non-insurance, which leads to a second decision as to how the losses, if any, will be funded. Transfer of the financial consequences is insurance, and insurance automatically provides the answer to funding of the loss consequences.*

In analyzing the benefits of captive insurance, it must be compared to the two basic alternatives of risk management: self-insurance and insurance. In distinguishing between the benefits of “captive insurance” and “self-insurance” or “insurance,” care must be taken to identify those benefits that are comparable and do not present a distinction for choosing between them on the basis of non-tax business reasons, and those benefits that are clearly distinct.

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* The definition of insurance as a transfer technique is widely accepted. Thus, insurance has generally been defined as follows: “From the viewpoint of a risk manager, insurance was defined as a technique that makes it possible to transfer the financial consequences of potential, accidental losses from the insured entity, family or individual to an insurer.” 1 C. Williams, supra note 6, at 224.
1. **Self-Insurance Versus Captive Insurance**

As a mechanism for funding loss consequences, self-insurance and captive insurance appear to be equally suitable. For example, whether one voluntarily decides to retain one's risk, or is forced to because coverage is unobtainable in the marketplace,\(^9\) funding loss consequences through a bank account or a controlled corporation presents little substantive difference. This conclusion can be illustrated through an analysis of risk management.

Risk management describes a person's reaction to the risks he bears. Of course, a person facing risks may be unaware of the risks or, being aware, may decide not to do anything about them. This is risk retention, which can be referred to as non-insurance.

A person may consciously decide to retain the uncertainty of the financial consequences of the risks he faces and provide for potential losses by making formal accruals on the company's books or by actually setting aside funds for future contingencies. Even though provision has been made for these contingencies, the person still retains the risks. These active risk retention devices are often called self-insurance.\(^10\)

Another risk management technique is the provision for potential losses through obtaining formal contracts of insurance with one's wholly-owned insurance affiliate.\(^11\) This is merely another form of active (non-passive) risk retention, as universally recognized in the theoretical and applied insurance and risk management literature.\(^12\) This is because a corporation that places its risks in an insurance company that it owns, either directly or through its parent or subsidiaries, is not relieving itself of its financial uncertainty. Through its ownership position, it retains the benefits and burdens of retaining the financial consequences of its risks.

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\(^9\) This factor was noted in Stearns-Roger, 577 F. Supp. at 835.

\(^10\) See Goshay, Corporate Self-Insurance and Risk Retention Plans 19 (1964). Goshay adopted the following definition: "[S]elf-insurance is the conscious retention of risk, the level of which has been limited within the financial capacity of the firm, emanating from a distribution of exposures which permit reasonable predictions as to future loss probabilities." Id. at 21.

\(^11\) See 1 C. Williams, supra note 6, at 135, 139, 224.

\(^12\) See generally P. Bawcutt, Captive Insurance Companies 26 (1982); M. Friedman, Price Theory 80 (1976); I. Pfeffer, Insurance and Economic Theory 47, 52-53 (1956); 1 C. Williams, supra note 6, at 135, 139, 224; Friedman & Savage, The Utility Analysis of Choices Involving Risk in Readings in Price Theory, 57-96 (1952).
noted insurance scholar has pointed out that "[i]n fact, if self-insurance involves the conduct of risk management 'according to all the sound principles and practices employed by insurance companies' it might be argued that captive insuring is the epitome of the self-insurance device."

There are, however, some practical differences between self-insurance and captive insurance where the form of insurance is used. An enterprise may have better access to reinsurance markets because unrelated insurers are more comfortable when the primary coverage is structured in a formal way. Also, where insurance coverage is required in dealings with unrelated parties including governmental units, captive insurance may be acceptable whereas self-insurance may not. Additional advantages may be available for international operations of U.S. enterprises, because captive insurance may be treated as insurance in foreign jurisdictions. The premiums may be deductible for foreign tax purposes, and the flow of premiums outside the territorial limits of these countries may be permitted even in countries with currency control laws. Where the insured is a foreign corporation, U.S. tax may not directly apply to these transactions, and captive insurance may still be a viable form in the international setting.

2. **Insurance Versus Captive Insurance**

Insurance transfers the financial uncertainty about business risks to another person in exchange for the payment of a premium. From the insured's point of view, the essential element of the insurance transaction is that no matter what insured risks may occur, the costs are known in advance. For the price of the premium,

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13 Goshay, supra note 7, at 85 (footnote omitted).

14 For an examination of the captive insurance issue under British tax law, see Finney, Captive Insurance Companies: A United Kingdom and United States Perspective, 1980 British Tax Rev. 115 (1985).

For two Canadian cases that dealt with this very issue, see Consolidated-Bathurst, Ltd. v. The Queen, [1985] 1 C.T.C. 142 (Fed. Ct.) (decision for government); Bonavista Cold Storage Co. v. M.N.R., [1983] C.T.C. 2093 (Tax Rev. Bd.) (decision in favor of taxpayer, on appeal to Federal Court).

15 In Mobil, the court found that payments by foreign subsidiaries to a foreign captive insurance company were not taxable as constructive dividends. Mobil Oil Corp. v. United States, 8 Cl. Ct. 555, 568 (1985). For the application of Subpart F of Part III of Subchapter N of the Internal Revenue Code to these transactions, see infra text accompanying notes 211-34.
the insured is protected from the financial costs of the risk within the limits of the policy.

An essential element of insurance is that risks are transferred from the entity whose activities naturally give rise to the risks to an entity whose investors accept such risks because of the potential profit they can earn thereby. Thus, insurers and the persons who own them are risk takers. They assume the potential financial consequences of risks of others in exchange for a premium payment.

Although a person may be able to predict, with considerable accuracy, his expected losses from risks, he can never know the actual losses until they occur. So long as the ultimate financial consequences of his risks are not transferred to another, a person remains the risk bearer. A person can choose to retain the financial consequences of his risks and predict the costs or attempt in one way or another to minimize these risks. However, when a person retains a risk, through self-insurance or captive insurance, there is always some uncertainty about the actual financial consequences of the events that may occur at a future date. The only way a person can relieve himself of the financial uncertainty is by entering into a contract under which an unrelated person (the insurer) will assume that uncertainty. Of course, the insured must have reason to believe that the person assuming the uncertainty will have the ability to honor the contract if the event occurs.

In comparing captive insuring with insuring with an unrelated party, the perceived advantages include handling otherwise uninsurable risks and the achievement of broader and deeper coverage. But the chief perceived advantage of captive insurance is cost reduction. If captive insurance is utilized, there is a potential reduction of the costs of insuring a pure risk for a company with better-than-average loss experience. In addition, the company benefits from a potential reduction of non-risk costs, including brokerage fees, administrative and claims adjustment expenses, and the retention of the potential underwriting and investment profit that an insurance company retains.16

However, there are also certain disadvantages with captive insurance. Most importantly, the enterprise is fully responsible for the financial consequences of its risks. Second, a captive must be capi-

talized with after-tax funds. This is a problem with self-insurance as well, to the extent that such capital is necessary to properly provide for potential financial consequences. Third, a captive, like self-insurance, requires additional costs to manage the program. Finally, a captive, unlike a pure self-insurance arrangement, may be subject to certain excise taxes. With the exception of this final item, the major advantages and the disadvantages of captives and self-insurance versus insurance with an unrelated party are the same.

C. Tax Accounting for Property/Casualty Insurance

The treatment of the insurance transaction under federal income tax laws is based on a unique set of rules of accounting for income and deductions that is highly favorable to both the insured and the insurance company. Before turning to a broader analysis of the tax issue, it is proper to focus on the practicalities of tax accounting for the different methods by which a business may manage the risks it faces.

1. Self-Insurance and Insurance

The tax treatment of self-insurance is well recognized and long established. A taxpayer is not entitled to deduct accruals to a self-insurance reserve. However, a taxpayer is entitled to deduct

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17 For example, § 4371 of the Internal Revenue Code imposes an excise tax of four percent on insurance and one percent on reinsurance premiums paid to a foreign insurer for property liability insurance. In a Private Letter Ruling, the Internal Revenue Service concluded that this excise tax is not applicable where a captive arrangement does not create insurance. Priv. Ltr. Rul. 7,904,047 (Oct. 25, 1978).


19 For a detailed examination of the authorities, see infra notes 45-58 and accompanying text.

20 But Congress has long provided special treatment for self-insurance. For example, in 1958 Congress passed an amendment to § 1231 of the Internal Revenue Code to provide special tax relief for the self-insured. See Technical Amendments Act of 1958, Pub. L. No. 85-866, § 49(a), 72 Stat. 1606, 1642 (now codified as amended at I.R.C. § 1231(a)(4)(C)). As the Senate Committee on Finance subsequently explained:

The 1958 amendment was enacted to benefit business taxpayers who self-insure their business properties. Casualty losses on their business properties were excepted
losses sustained during the taxable year under section 165 of the Internal Revenue Code\textsuperscript{21} when the "all events test" is satisfied; that is, when the liability is fixed, the amount of the loss can be determined with reasonable accuracy, and economic performance has occurred.\textsuperscript{22}

The amount of the casualty loss that can be deducted under section 165 of the Code is limited to the lesser of (1) the difference between the fair market value of the property before the occurrence of the casualty and the fair market value of the property after the casualty, or (2) the adjusted basis of the property.\textsuperscript{23} Should there be a total loss, a business taxpayer may take a deduction for the full adjusted basis.\textsuperscript{24}

A taxpayer who has obtained insurance to cover his casualty risks, however, receives markedly different treatment under the tax laws, due to a unique set of rules of accounting for income and deductions that is highly favorable to the insured and the insurer. From the viewpoint of the insured, premium payments for property and liability insurance are ordinary and necessary business expenses and deductible under section 162 of the Code. This is so even though the insured may receive claims payments smaller than, equal to, or even greater than the amount of the premium from the insurance company. The reason is that by paying the pre-

\begin{footnotesize}
\textsuperscript{21} Section 165 provides, as a general rule, that "[t]here shall be allowed as a deduction any loss sustained during the taxable year not compensated for by insurance or otherwise." I.R.C. § 165(a).

\textsuperscript{22} See I.R.C. § 461(h)(1), (4); Treas. Reg. § 1.461-1(a)(2); see also United States v. Anderson, 269 U.S. 422, 424 (1926); Treas. Reg. § 1.165-1(b). Specifically, § 461 provides that in the case of any workers compensation or tort liability, where payment to another party is required, economic performance does not occur until payment is made. See I.R.C. § 461(b)(2)(C).

For a thorough discussion of interpreting the all events test in relation to self-insurance, see Bradley & Winslow, supra note 18, at 220-26.

\textsuperscript{23} Treas. Reg. § 1.165-7(b)(1).

\textsuperscript{24} Id. (flush language). This discussion presumes a taxpayer involved in business or investment deducting casualty losses under § 165(c)(1)-(2) of the Code. There are special limitations on the deduction of personal casualty losses sustained by individuals. See I.R.C. § 165(h).
\end{footnotesize}
mium the insured has transferred the financial uncertainty of its risks to the insurance company. There is no certainty as to what, if anything, the insured will receive by way of recovery.

An insurance recovery is gain to the insured under section 61 of the Code.\(^{28}\) Losses of the insured are deductible under section 165 of the Code in the same manner as described for self-insured losses. To the extent a loss is compensated by insurance, the loss is not deductible, and the insurance recovery is not income. Thus, for example, if a person’s building worth $100 was completely destroyed by fire, but the adjusted basis of the building was $20, that person would only be entitled to a loss deduction of $20 under section 165.\(^{26}\) Should that person have insurance and receive an insurance recovery of $100, the insured would not be entitled to a deduction and would have a realized gain of $80, because the insurance recovery is $80 more than the basis in the property.

Section 1033(a)(2) of the Code, however, permits non-recognition of gain on the receipt of insurance proceeds if the insured purchases property similar or related in use to that which was destroyed.\(^{27}\) The self-insured, on the other hand, must use after-tax dollars to purchase replacement property. However, the insured will have a substituted basis in the replacement property, whereas the self-insured will have a new cost basis in the replacement property equal to its fair market value. Therefore, in our example above, the trade-off between insured and self-insured is that the insured will have a $20 substituted basis in the new asset, whereas the self-insured will receive a full cost basis of $100 in the new asset. The insured thus has a lower basis for depreciation purposes and a built-in deferred potential gain of $80.

2. Captive Insuring

Typically, the insured is only concerned with its own tax treat-

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\(^{28}\) Section 61 provides, as a general rule, that “[e]xcept as otherwise provided . . . gross income means all income from whatever source derived.” I.R.C. § 61(a). Because insurance recoveries are not excluded from taxation under other Code sections, this general rule subjects such recoveries to taxation.

\(^{26}\) See supra note 23 and accompanying text.

\(^{27}\) Section 1033 provides, in pertinent part, that if “the taxpayer . . . purchases other property similar or related in use to . . . [the insured property that was lost], . . . the gain shall be recognized only to the extent that the amount realized . . . [from insurance proceeds] exceeds the cost of such other property.” I.R.C. § 1033(a)(2)(A).
Captive Insurance

ment and not with the tax treatment of the insurance company. When the insured owns the insurer, however, the insured is directly concerned with the tax treatment of insurance companies, and tax accounting for property casualty insurance companies presents some major differences from accounting for other corporations.

Stock casualty and property insurance companies are generally taxable as other corporations under the Code. There are, however, two essential differences: (1) the manner in which insurance companies compute their gross income, and (2) the manner in which deductible losses from underwriting (as opposed to investment) are computed. Each of these differences will be discussed in turn.

Gross income to an insurance company includes only such income from premiums that has been “earned” during the taxable year. Thus, premiums attributable to a period of time after the close of the taxable year are not included in gross income for that year even though received by the insurance company. These amounts are classified as a reserve for unearned premiums.

Losses that are deductible by insurance companies cover a wide variety of contingent liabilities under section 832(b)(5). As the Internal Revenue Service has noted: “Losses incurred . . . include liability for claims reported, whether adjusted, in the course of adjustment, or resisted, as well as the liability for claims arising during the taxable year but not reported.” Thus, insurance companies are permitted to set up reserves for contingent liabilities including reported (whether or not they will be paid) and unreported claims (“made on the basis of the facts in each case . . . and the company’s experience with similar cases”), and deduct these reserves as losses during a taxable year.

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28 See I.R.C. § 831.
29 I.R.C. § 832(b); Treas. Reg. § 1.832-4. However, § 832(b) was amended by the Tax Reform Act of 1986 to provide that only 80% of unearned premiums is excluded from income. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1021(a), 100 Stat. 2085, 2395 (to be codified at I.R.C. § 832(b)(4)(B)).
31 Id. at 597.
32 Id. However, the Tax Reform Act of 1986 amended § 832(b)(5)(A) and added new § 846 to require discounting to present value for insurance losses. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1023, 100 Stat. at 2399-2404 (to be codified at I.R.C. §§ 832(b)(5)(A), 846).
In contrast, the general rules of tax accounting prohibit the deferral of an item of income when the earning of the income will take place in a later taxable year, even though deferral would be in accord with sound accounting practice.\textsuperscript{33} Similarly, the general rules of tax accounting prohibit the deduction of future estimated expenses even when such deduction is in accordance with sound accounting practice.\textsuperscript{34}

The foregoing sets forth some of the tax accounting advantages afforded insurance transactions, both to the insured and the insurer. Because of these advantages, a captive insurance arrangement is not a simple "wash" between income and deductions of the related insured and insurer. If the companies were consolidated for income tax purposes, there would still be substantial deferral of tax obligation with regard to the insured and insurer as compared with a self-insurance scheme.

Many captive insurance companies, however, are not incorporated in the United States, but in foreign jurisdictions. These captive insurers could not file consolidated returns with their parent corporation.\textsuperscript{35} However, many U.S.-owned captive insurers are incorporated in countries which impose little or no income taxes.\textsuperscript{36} Thus, these captive insurers relinquish some of the advantages of


\textsuperscript{34}Section 461(h)(1) provides that the all events test is not satisfied until economic performance occurs. I.R.C. § 461(h)(1); see supra note 22 and accompanying text; see also Simplified Tax Records v. Commissioner, 41 T.C. 75, 82 (1963).


\textsuperscript{35}Generally, only United States corporations which are property casualty insurance companies can be included in a consolidated income tax return. This is the result of the definition of includable corporations for consolidated return purposes, which includes all corporations (80% or more owned) except certain life insurance companies, mutual insurance companies, and foreign corporations. See I.R.C. § 1504(a), (b)(2), (3).

\textsuperscript{36}See, e.g., 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 617 (1986). Barbados is one such country, where incorporation of captive insurance companies is popular.
tax accounting for insurance companies (but their parent companies relinquish none of the advantages of tax accounting for the insured), in exchange for minimal local income tax and the deferral of U.S. income tax liability. The computation of these affiliates’ taxable income under the rules of tax accounting for insurance companies would still be important, however, for purposes of Subpart F of the Code, which deals with the taxation of the shareholders of controlled foreign corporations. The accounting principles for insurance companies outlined above are equally valid for Subpart F purposes.\footnote{I.R.C. § 953. For a discussion of Subpart F of Part III of Subchapter N of the Code and its application to the captive insurance issue, see infra notes 211-34 and accompanying text.}

The tax deferral due to foreign incorporation of a captive insurance company, however, can have a negative impact where a captive insurer incurs an overall loss. A U.S. insurance company can utilize a loss in determining its U.S. income tax consequences. A foreign insurance company, however, not being a U.S. taxpayer, cannot utilize losses to offset U.S. income. On the other hand, a corporation deducting premiums paid to its foreign captive insurers would obtain an after-tax profit when little or no loss occurs caused solely by the federal tax savings. Thus, the foreign insurer presents less certain, but potentially much greater, tax advantages than a domestic captive insurer, depending on the actual consequences of the group’s losses.\footnote{This discussion has largely ignored the presence of non-loss costs (like administrative expenses) on the assumption that the non-loss costs associated with self-insurance and captive insurance will be similar, and that they are deducted by the self-insured directly and by the captive insured through the premium payment. For many property casualty lines these costs are often minimal, as was the case in \textit{Mobil}. See \textit{Mobil}, 8 Cl. Ct. at 559.}

The tax advantages of foreign captives, however, may be largely illusory for years governed by the Subpart F provisions of the Tax Reform Act of 1986.\footnote{See infra notes 211-34 and accompanying text.}

### III. Insurance: Risk Transfer and the Courts’ Approaches

Section 162(a) of the Code provides for the deductability of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Treasury Regulations provide that among the allowable business expenses are insurance premiums against losses due to fire, storms, theft, accident, or
similar losses suffered by a business.\(^4\)

Although the term "insurance" is not defined in the Code, two well-established principles determine whether a transaction cast in the form of insurance actually constitutes insurance for federal tax purposes. First, the Supreme Court held, in *Helvering v. Le Gierse*,\(^4\) that a transaction must involve risk transfer and risk distribution to constitute insurance for tax purposes.\(^4\) Second, sums set aside pursuant to a self-insurance plan are not deductible insurance expenses.\(^4\) Not only is there no risk transfer in a self-insurance plan, but sums set aside are not business "expenses," since the taxpayer retains a proprietary interest in the fund and the "payments" are merely a reserve for future contingent liabilities.\(^4\) This follows even when the funds are transferred to and administered by an independent agent or insurance company.\(^4\)

An important feature of court cases dealing with self-insurance is that they do not represent an application of the doctrine of substance over form. Indeed, the courts dealt directly with the actual form of the situation. The treatment of self-insurance represents the application of accepted theory to the accrual of expense deductions under the all events test. Also, when considering the alternate theory of the courts that there is no risk shifting in a self-insurance plan, one readily sees that there is no *transfer* of anything where the taxpayer merely accrues an expense on its books, and there is no *risk* being transferred even where third parties are involved because the third parties have not accepted the consequences of the risk but have merely accepted the responsibility for managing the funds. With self-insurance, there is no need to determine the reality behind the form because the form itself expresses the actual intention of the parties and leads to the proper tax result. Captive insurance, on the other hand, employs a form which, if accepted, requires a different tax result.

\(^{40}\) *Treas. Reg. § 1.162-1(a).*

\(^{41}\) 312 U.S. 531 (1941).

\(^{42}\) Id. at 539-40.

\(^{43}\) See, e.g., *Spring Canyon Coal Co. v. Commissioner*, 43 F.2d 78, 80 (10th Cir. 1930), cert. denied, 284 U.S. 654 (1931).

\(^{44}\) Id., 43 F.2d at 79.

\(^{45}\) See, e.g., *Steere Tank Lines, Inc. v. United States*, 577 F.2d 279 (5th Cir. 1978), cert. denied, 440 U.S. 946 (1978); *Spring Canyon Coal*, 43 F.2d at 78.
A. Risk Transfer and Risk Distribution

1. The Le Gierse Opinion

The analysis of Helvering v. Le Gierse involved an application of the familiar tax doctrine of substance over form. In that case, an elderly woman entered into two contracts with an unrelated insurance company. The first contract was a $25,000 life insurance policy naming the insured's daughter as beneficiary, for which the insured paid a single premium of $22,946. As a condition to the issuance of the life insurance policy, the insurance company required the insured to purchase, for a single premium of $4,179, an annuity contract providing annual payments of $589.80 for life. The effect of the annuity and insurance policies was that the one neutralized the actuarial risk customarily inherent in the other. The insured died within a month of the purchase of these policies and the question presented was whether the proceeds of the $25,000 life insurance policy were "insurance" and thus exempt from the federal estate tax.

In determining whether the proceeds received constituted insurance, the Supreme Court viewed the life insurance policy and the annuity policy as part of one plan and concluded, since the annuity contract neutralized the risk customarily inherent in a life insurance contract, that they were not insurance. According to the Court, the proceeds of a life insurance policy could only constitute an amount receivable as insurance, if they were received as a result of a transaction involving an actual risk, since "[h]istorically and commonly insurance involves risk-shifting and risk-distributing."

Le Gierse is also an example of the application of the step transaction doctrine, enunciated later by the Supreme Court in Commissioner v. Court Holding Co. The essence of the doctrine is that "several transactions should be treated as one where, on an objective view of what took place, they could be said to be interdependent." The insured in Le Gierse, although entering into a for-

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46 312 U.S. at 536.
47 Id. at 537.
48 Id.
49 Id. at 541.
50 Id. at 539.
51 324 U.S. 331 (1945).
52 Rice, supra note 4, at 1046.
mal contract of life insurance with an insurer, did not in reality transfer the actuarial risk to the insurer, so the contract did not constitute insurance for federal tax purposes.\textsuperscript{53}

2. Revenue Ruling 77-316

The Service relied upon Le Gierse and the self-insurance analysis in its first formal pronouncement on captive insurance in Revenue Ruling 77-316.\textsuperscript{54} This Ruling held that insurance did not exist between a parent (or affiliates) and its wholly-owned captive.\textsuperscript{55} The Ruling considered three situations in which a parent corporation and its subsidiaries had entered into formal insurance contracts with a wholly-owned insurance subsidiary: first, direct insurance between operating companies and their insurance company; second, indirect insurance between operating companies and an unrelated insurance company that reinsured a portion of the risk with the taxpayer’s wholly-owned insurance affiliate; and finally, direct insurance between operating companies and their wholly-owned insurance affiliate that reinsured a significant portion of the risks with an unrelated insurance company.\textsuperscript{56} With respect to the risks carried or retained by the wholly-owned insurance affiliate, the Ruling found that: “In each situation described, the insuring parent corporation and its domestic subsidiaries, and the wholly owned ‘insurance’ subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss.”\textsuperscript{57} Because of this finding, the Ruling concluded that risk transfer and risk distribution were not present under these circumstances.\textsuperscript{58}

3. The Captive Cases: Risk Transfer Focus

Courts have largely ignored the economic family terminology of Revenue Ruling 77-316 and have primarily focused on the concept

\textsuperscript{53} 312 U.S. at 541.
\textsuperscript{54} 1977-2 C.B. 53.
\textsuperscript{55} Id. at 53. For a discussion of the historical development by the Service of this view, see Greene, supra note 16, at 257.
\textsuperscript{56} 1977-2 C.B. at 53-54.
\textsuperscript{57} Id. at 54.
\textsuperscript{58} Id. at 55.
of risk transfer. The results, however, have been the same. Courts have uniformly found that risk transfer is not accomplished where the insured wholly owns (either directly or by reason of its affiliation with the owner) the insurer. 68

The underlying rationale of these cases is that the arrangements were not insurance because risk was not transferred. 69 The results are based upon the courts' conclusions about the fundamental economic reality of the transactions. 70 A related conclusion running through recent court opinions is that captive insuring is merely a self-insurance device. 71 The insurance and economics literature fully supports these views. 72

The quintessential difference between a captive insurance transaction and an insurance transaction is that the person who owns the insurer does not shift his uncertainty to another; he still retains the full uncertainty he had before the affiliate issued a formal contract of insurance. 73 Whatever the financial consequences, the person bears them through his ownership position. This person has not parted with a premium, nor with the financial consequences of the risk; the true insured has parted with both. Moreover, in recent cases these differences were clearly recognized in

68 See cases cited supra note 1. For a discussion of two cases where only partial ownership was present, see infra notes 157-75 and accompanying text.

69 See, e.g., Stearns-Roger Corp. v. United States, 774 F.2d 414, 415 (10th Cir. 1985) (self-insurance does not constitute insurance because there is no shifting of risk to others).

70 In four cases, the government offered the testimony of Dr. Irving H. Plotkin, Vice-President of Arthur D. Little, Inc., on the theories and practicalities of insurance applicable to captive insurance. Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986); Stearns-Roger Corp. v. United States, 577 F. Supp. 833, 835 (D. Colo. 1984), aff'd, 774 F.2d 414 (10th Cir. 1985); Mobil Oil Corp. v. United States, 8 Cl. Ct. 555, 563 (1985); Humana, Inc. v. Commissioner, 1987 Tax Ct. Curr. Reg. Dec. (CCH) Dec. No. 43,666, at 2704-06 (Jan. 26, 1987). In Mobil, Dr. Plotkin "was qualified as an expert on the economics of insurance." 8 Cl. Ct. at 563.

71 See, e.g., Stearns-Roger, 774 F.2d at 416. The Tenth Circuit stated:

The parent in the case before us did not receive protection that would have been provided by "insurance." The reality of the transaction has to be recognized. The comparison of the arrangement here made to self-insurance cannot be ignored. The parent provided the necessary funds to the subsidiary by way of what it called "premiums" to meet the casualty losses of the parent. The subsidiary retained these funds until paid back to the parent on losses. This does not appear to have different consequences than did the payments in Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930).

72 See sources cited supra note 12.

73 See supra text accompanying notes 15-17.
reports prepared by corporate risk managers advising management of its options. For example, in Mobil Oil Corp. v. United States, an employee explained:

Approaches to insurance can be roughly categorized as outside insurance, self insurance and non-insurance. Outside insurance, of course, refers to covering insurable risks by paying a premium to a non-affiliated insurance company in return for an agreement that the insurance company will indemnify the insured for losses suffered. Self insurance is usually handled by setting aside premiums out of current earnings into a reserve for self-insurance; losses are charged against this reserve. Self-insurance can also be worked through an insurance affiliate. Under this system, operating subsidiaries pay premiums to an affiliated insurance company. Non-insurance means that no provision at all is made for the insurable risks concerned.

4. Net Worth Variant to the Risk Transfer Focus

Some courts have taken a related but somewhat different approach to the analysis of risk transfer. They have concluded that an examination of the economic reality of the transaction as reflected in the net worth of the participants shows a lack of risk transfer. For example, as noted by the trial court in Beech Aircraft Corp. v. United States:

An attempt by a parent corporation to transfer risk to a subsidiary by a contract of insurance does not succeed in doing so as a matter of economic reality. This is because the same related economic family continues to be responsible for the actual losses that occur. Where the relationship of parent and captive entity exists, as here, the risk becomes a paper transfer and the actual loss experience reduces or increases the net worth of the subsidiary and the net worth of the parent reflects the reduction or increase in the value of its subsidiary on the parent's balance sheet. It is conceivable, though unlikely, that if no losses were encountered, the deduction of purported insurance premiums could become a tax loophole for the parent company.

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86 Defendant’s Exhibit No. 7, app. 2, at 1, Mobil, 8 Cl. Ct. 555 (No. 358-78) (reprinting Adams, Economics of Self Insurance, in An Insurance Program for Mobil Overseas (1958)) (copy on file).
87 1984-2 U.S. Tax Cas. (CCH) ¶ 9803, at 85,404 (D. Kan. 1984), aff’d, 797 F.2d 920 (10th
The net worth analysis is based in part on the actual way the account-}

ing profession treats captive insurance for financial reporting purposes. Neither self-insurance nor captive insurance has any effect for financial accounting purposes; only actual losses are taken into account.68 This position is based on the account-

ing profession's view of the practicalities of risk retention and risk trans-

fer. According to the Financial Accounting Standards Board ("FASB"), neither self-insurance nor captive insurance is insurance.69 This position recognizes the basic distinction between risk retention and the transference of risk through insurance with an independent insurer.70 Additionally, the FASB concludes that neither self-insurance nor captive insurance eliminates or protects an enterprise from risk: "Insurance or reinsurance reduces or eliminates risks and the inherent earnings fluctuations that accompany risks. Unlike insurance and reinsurance, however, the use of 'accounting reserves' does not reduce or eliminate risk."71

The net worth analysis is also a reflection of a common sense approach to the effect on an insured of captive insurance. An in-

sured who obtains insurance from an unrelated insurance company and a person who obtains a formal contract of insurance from an insurance affiliate face profoundly different practical situations. In

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68 Under Generally Accepted Accounting Principles ("GAAP"), a business enterprise is not permitted to accrue contingent liabilities unless it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. See Accounting for Contingencies, Statement of Financial Accounting Standards No. 5, ¶ 8 (Fin. Accounting Standards Bd. 1975) [hereinafter FASB Statement No. 5]. FASB Statement No. 5 recognizes that the absence of insurance for casualty risks "consti-

tutes an existing condition involving uncertainty about the amount and timing of any losses that may occur, in which case a contingency exists." Id. at ¶ 27. FASB Statement No. 5 further provides that: "Uninsured risks may arise in a number of ways, including (a) nonin-

surance of certain risks or coinsurance or deductible clauses in an insurance contract or (b) insurance through a subsidiary or investee to the extent not reinsured with an independent insurer." Id. (footnote omitted).

Usually, a company will be required to report an investment in a subsidiary using the consolidated method of accounting where more than 50% of the voting stock of the subsidiary is owned by the parent. See ARB No. 51, Consolidated Financial Statements ¶¶ 1, 2 (1959). The equity method of accounting for investments in common stocks is presumed to be applicable where the investment is 20% or more of the voting stock. APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock ¶ 17 (1971).

69 See FASB Statement No. 5, supra note 68, ¶ 27.

70 Id. at ¶¶ 61, 66.

71 Id. at ¶ 65.
an unrelated situation the insured has transferred the financial consequences of potential casualties to an unrelated party. Thus, the insured is basically indifferent from a financial viewpoint as to whether or not he suffers a loss because he will be reimbursed in accordance with his insurance policy. The premium payment is spent in exchange for peace of mind. Because the premium has been spent, he is in the same economic position whether or not he suffers a loss and is reimbursed for it.

The person who obtains a formal contract of insurance from a captive, however, is not indifferent from a financial viewpoint. He has a direct financial stake in whether a loss occurs and a claim payment is made because both the premium payment and risk are within the same economic family. Without a loss, he does not receive a claim payment, but the captive and the group still have the premium. With a loss, the "insured" affiliate receives a claim payment, but the group's premium or capital that was used to pay the claim has been consumed in making the "insured" affiliate "even." Only the effects of the actual loss by the "insured" affiliate will be directly reflected in the parent's books. In essence, the payment of the premium by the "insured" affiliate and the receipt of the premium payment by the insurance affiliate cancel each other; this group is left with the potential for actual casualties and the financial consequences of those potential casualties.72

5. Implications

As the foregoing analysis demonstrates, only when a firm obtains real insurance are its financial costs independent of whether or not the peril actually comes to pass. The firm's costs are equal to the insurance premium and, within the policy's limits, are known in advance with certainty. Just the opposite is true with any form of self-insurance: the actual costs to the firm are a direct, dollar-for-dollar function of what perils in fact come to pass and what their financial consequences turn out to be.

The obvious conclusion from this analysis is that courts are correct in concluding that in reality captive insurance transactions are not insurance.73 The question remains whether this reality should

72 For an elaboration on the comparison between insurance and self-insurance, see supra text accompanying notes 15-17.
73 See cases cited supra note 1.
be adopted for tax purposes. The focus of analysis for economics is normally the concept of the "firm": a total enterprise composed of all related entities. The accounting profession also focuses on an economic enterprise as a whole. Taxation, however, adopts as its starting point the view that the separately incorporated components of a firm or an economic enterprise are separate taxpayers. Thus, tax law cannot blindly follow the position of other disciplines, such as economics or accounting, without justifying this approach in terms of the fundamental principles of taxation. Just as important for the integrity of our tax system, however, is that tax law should face the consistent approach taken to captive insurance by other disciplines and the inherent practicalities underlying these approaches. The analysis of fundamental tax principles, and their application to the captive insurance situation, is a task to which we now turn.

IV. SEPARATE CORPORATE ENTITY AND ECONOMIC REALITY

Courts have uniformly held that where a parent or its affiliates have entered into a formal contract of insurance with an insurance company that it wholly or substantially owns, risk transfer, and hence, an insurance relationship, has not been established. Moreover, as has been pointed out, this conclusion is solidly supported by the commonly understood view found in the insurance, economics, and accounting literature that the captive insurance arrangement is a risk-retention device and does not create an insurance relationship. This conclusion is based on the factual premise of an ownership relation between insured and insurer. This position, however, must be reconciled with the doctrine of separate corporate entities.

The courts, however, have dismissed any conflict. The most complete articulation of this view is found in the Tax Court's opinion in Clougherty Packing Co. v. Commissioner:

There are numerous situations in the tax law, both statutory and case law, where the separate nature of the entity is not disregarded

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74 See supra note 68.
76 See cases cited supra note 1.
77 See supra notes 8-17 & 68-72 and accompanying texts.
78 See infra notes 80-83 and accompanying text.
but the transaction, as cast between the related parties, is reclassified to represent something else, e.g., reasonable compensation or dividend, loans or contributions to capital, loans or dividends, deposits or payments, or other recharacterization such as permitted under section 482 . . . . We have done nothing more . . . but to reclassify, as nondeductible, portions of the payments which the taxpayer deducted as insurance premiums but which were received by the taxpayer’s captive insurance subsidiaries. 79

To taxpayers who have questioned the government’s position in many forums, this statement may appear somewhat conclusory since it deals with what is essentially the heart of the taxpayers’ cases. It does, however, identify the crucial issue: the relationship between the doctrines of separate corporate entities and substance versus form as it applies to this issue.

A. Basic Tax Principles: Separate Corporate Entities Doctrine

The doctrine of separate corporate entities has as its focus the determination of who is the proper taxpayer, a corporation or the interests that own it. Such cases as Moline Properties, Inc. v. Commissioner, 80 and National Carbide Corp. v. Commissioner, 81 have established the essence of the doctrine: whatever the purpose for organizing a corporation by the taxpayer, “so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.” 82 Moline Properties thus established the principle that business activities can be divided between related entities and this will be respected for tax purposes. 83 Moreover, not even the government can disregard a corporate entity and tax a shareholder on the profits attributable to the business activity of his corporation.

79 84 T.C. 948, 960 (1985), aff'd, 811 F.2d 1297 (9th Cir. 1987). The Ninth Circuit stated that its holding does not ignore the separate legal status of the captive insurer. See 811 F.2d at 1305, 1307; see also infra note 140.
80 319 U.S. 436 (1943).
81 336 U.S. 422 (1949).
82 Moline Properties, 319 U.S. at 438-439. In Moline Properties, the question presented was whether the taxpayer corporation could exclude realized capital gains of the corporation and include them, instead, in the income of its sole shareholder. The Court, agreeing with the government, decided that the corporation could not. Id.
83 Id.
B. Basic Tax Principles: Substance Over Form And Sham Transaction Doctrines

The doctrinal approach to taxation described above does not require that the government be bound by the form that taxpayers employ for transactions between related entities, whether individual or corporate. In *National Carbide*, the Supreme Court applied general assignment of income principles to determine which "separate corporate entity" should be taxed on the income.\textsuperscript{84} Further, the courts have long employed the substance over form and sham transaction doctrines\textsuperscript{85} in examining the tax consequences of transactions between related parties. These doctrines essentially provide that in certain circumstances, the form of a transaction will be recast by the courts so that the tax consequences will comply with the true substance or economic reality of the transaction.

An understanding of when courts will employ these doctrines begins with the practical reality that "[t]he whole purpose of having any doctrine at all is to prevent tax avoidance."\textsuperscript{86} Thus, the application of the doctrines depends upon the perception by the tax administrator and the courts that the taxpayer is attempting to take advantage of some anomaly in the tax system that produces a favorable tax result, and resort to this doctrine depends in the first instance upon the discretion of the tax administrator. The presence of tax avoidance motivation, however, does not provide a basis for distinguishing between the legitimate and illegitimate transactions, because it is recognized that tax avoidance motivation is to be disregarded unless a statutory provision makes it a relevant inquiry.\textsuperscript{87}

Since tax avoidance motivation is to be disregarded, what is the relevant inquiry for the courts? Once a court has determined the

\textsuperscript{84} 336 U.S. at 436.

\textsuperscript{85} The government has apparently not argued that the insurance affiliates are sham corporations, perhaps because such an argument would narrowly define the situations its position would cover, i.e., making the argument inapplicable where the insurance affiliate accepts the risks of unrelated parties. See infra notes 173-210 and accompanying text. The effect, however, of disqualifying the transactions as insurance where the captive insures the risks of the parent organization may be to rob the captive of any business purpose. To date, however, it does not appear that the government has sought the reallocation of the investment profits from the captive to the parent.

\textsuperscript{86} Rice, supra note 4, at 1035.

\textsuperscript{87} See Gregory v. Helvering, 293 U.S. 465 (1935). Sections 269 and 482 are examples of provisions stating that a tax avoidance motive is relevant. See I.R.C. §§ 269, 482.
relevant fiscal facts

a preliminary question to be answered is whether the . . . form put forward by the taxpayer or other parties is really intended as such, or whether he or they may have intended a different legal structure in reality, in which case the nominal . . . form is not congruent with the economic and social reality, and another . . . form must therefore replace the former.88

Such a situation exists where the court discovers the presence of facts normally not part of the formal arrangement that demonstrate the invalidity of the formal arrangement. This is in essence the notion of a sham transaction.

The case of F.R. Johnson Products Co. v. Commissioner89 illustrates this approach. There the taxpayer entered into health insurance contracts on behalf of its employees with its wholly-owned captive. The court, however, examined the actual conduct by the parties and noted two important facts: (1) the taxpayer “never attempted to accumulate the necessary cash reserve to conduct such a business”,90 and, (2) the taxpayer never actually “paid any insurance premiums.”91 The arrangements were obviously shams and the court concluded that the transactions were not insurance.92

A related problem is found in Carnation Co. v. Commissioner where the insured guaranteed the integrity of an insurance company.93 A guarantee indicates that the insured and the insurer did not really intend to transfer any risk. The actual conduct of the parties was therefore not in accordance with what is expected of an insurance arrangement, so the transaction was simply a sham.94 Thus, sham situations may exist in the insurance context where an insurance company is not receiving premiums and paying claims in accordance with the contract,95 does not have sufficient capital to cover the risks accepted,96 or has protection in the form of a guar-

89 43 T.C.M. (CCH) 705 (1982).
90 Id. at 719.
91 Id.
92 Id.
93 640 F.2d 1010, 1012 (9th Cir.), cert. denied, 454 U.S. 965 (1981).
94 Id. at 1013.
95 See, e.g., F.R. Johnson Products, 43 T.C.M. (CCH) at 718-19.
96 See, e.g., Beech Aircraft, 1984-2 U.S. Tax Cas. (CCH) ¶ 9803, at 85,404 (D. Kan. 1984) (mentioning the lack of proper capitalization as a factor), aff'd, 797 F.2d 920 (10th Cir.
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antee of the loss exposures formally transferred.97

Most captive insurance arrangements presented to the courts cannot be so easily resolved. Most cases present situations where the financial facts, including the formal insurance arrangements and the actual conduct of the parties, are openly presented to the tax authorities, and the actual conduct of the parties formally complies with the insurance form. Simply put, the taxpayer carefully ensures that the transactions and the insurance affiliate comply with sound insurance practice. Where the form and the actual intent of the parties appear to be congruent, the issue becomes whether the forms openly presented conceal the true economic reality that would require a different tax result.

In order to gain a sense of where this aspect of the doctrine of substance over form will prevail, one must examine the principal cases in this area. In Gregory v. Helvering,98 the taxpayer had caused her corporation to spin off certain assets into a newly-formed corporation, which was then promptly liquidated.99 The Supreme Court was faced with the question of whether this transaction was a tax-free reorganization, where the taxpayer had formally complied with the definitional sections in the Code.100 Though it was clear that the transaction had been structured solely for tax reasons, the Court recognized that tax motivation is to be disregarded if a reorganization in reality was effected. The Court, however, held that the reorganization was not effective, in spite of technical compliance with the statute.101

1986).

97 See, e.g., Carnation, 640 F.2d at 1013.
99 Id. at 467.
100 Id. at 469.
101 Id. Writing for the Second Circuit panel that considered Gregory, in a famous passage Judge Learned Hand said:

We agree with the Board [of Tax Appeals] and the taxpayer that a transaction, otherwise within an exception of the tax law does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. . . . Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate
The Court's approach was to interpret the statute in light of its purpose. It found in the statute an essential requirement that a reorganization requires a business purpose, which was not readily perceived from the literal language of the statute. Thus, the transaction in question was not a reorganization "because the transaction on its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice over reality and to deprive the statutory provision in question of all serious purpose."

In *Higgins v. Smith*, the Court amplified this approach. The government had disallowed a claimed loss deduction on the sale of securities to a taxpayer's wholly-owned corporation. The corporation had been in existence for a number of years, and the government neither challenged the corporation's "separate existence" nor the price at which the sale had taken place. Instead, the government's contention, and the Court's holding, was that the loss had not been "sustained" within the meaning of the Code, because the taxpayer maintained control of the stock through his ownership of the corporation, and there was not "enough of substance in such a sale finally to determine a loss."

In *Crosby Valve & Gage Co. v. Commissioner*, a subsidiary of a charitable organization had made a "charitable contribution" to its parent. The question presented was whether the subsidiary was entitled to a charitable contribution deduction for its payment. The First Circuit, recognizing that the taxpayer had complied with the literal language of the Code for deductibility, nevertheless held that the payment was not a charitable contribution but a dividend payment. Reviewing the charitable contributions tax scheme, the court determined that it was not Congress' intent to confer a de-

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words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.


102 293 U.S. at 469.
103 Id. at 470.
104 308 U.S. 473 (1940).
105 Id. at 475.
106 Id. at 476.
107 Id.
108 380 F.2d 146 (1st Cir. 1967).
109 Id.
110 Id. at 148.
duction in this situation.\textsuperscript{111}

C. Application of Tax Principles to Captive Insurance

The inquiry, therefore, is to determine whether the substance or the reality of the transaction was within Congress' intended meaning. In \textit{Gregory v. Helvering}, the Court concluded that a transaction that lacked a business purpose could not be respected for tax purposes.\textsuperscript{112} Thus, in examining captive insurance, one level of inquiry is to determine whether a business purpose, other than tax motivation, exists for setting up and entering into a transaction with an insurance affiliate.

Captive insurance is superior to normal self-insurance for several business reasons.\textsuperscript{113} Captive insurance provides the form that legitimizes the transfer of funds among related entities and answers the concerns of third parties that the separate legal entity has adequate resources to cover potential losses. These reasons are related, however, to the overall business goal of captive insurance. This overall business purpose must be evaluated in its practical economic context. The objective of captive insurance is to conduct a risk-retention program according to the sound principles of insurance operations, while at the same time acknowledging that the financial responsibility for those risks is retained. The business purpose for captive insurance is to self-insure intelligently and to provide funding for loss exposures.

Typically, insurance affiliates are set up primarily to handle the exposures of the parent organization. Often, however, the insurance affiliate will insure the risks of unrelated parties. Certainly, insurance of unrelated parties supplies a sufficient business purpose for recognizing the reality of the insurance affiliate. However, the business purpose for the parent organization in insuring with its insurance affiliate, which is to carry out a risk-retention scheme for its own risks, does not change due to the "reality" of the affiliate's organization.

The presence of a business purpose for a transaction, however, does not necessarily lead to the conclusion that the form of a transaction will prevail. A different level of inquiry into legislative

\textsuperscript{111} Id.
\textsuperscript{112} 293 U.S. 465, 469 (1935).
\textsuperscript{113} See supra notes 11-15 and accompanying text.
intent is to examine the object of the statute either standing
alone\textsuperscript{114} or in the context of other Code provisions.\textsuperscript{115} Certainly, in 
\textit{Higgins v. Smith}, there may have been a business purpose for the
transfer of the securities from the taxpayer to the corporation, be-
cause the corporation probably used them in its trade or business
of buying and selling securities.\textsuperscript{116} The Court, however, found that
only losses sustained could be deducted, without regard to the bus-
iness purpose of the transaction.\textsuperscript{117}

Captive insurance is analogous to the situation in \textit{Higgins} be-
cause deduction of premiums depends on section 162 of the Code,
which requires an ordinary and necessary expenditure incurred
within the taxable year.\textsuperscript{118} An insurance premium is consideration
for the promise by the insurer to pay for incurred losses within the
limits of the policy. The insured has, in effect, fixed its loss by the
amount of the premium. The amount of the loss from any casualty
covered by the contract will be no greater or less than the amount
of the premium.\textsuperscript{119} Arguably, the insurance premium payment,
viewed as a prepaid loss, has not been "sustained" within the
meaning of \textit{Higgins} when paid to an insurer the insured owns be-
cause of the latter's continued control of the fund. This compari-
son does suggest that captive insurance does not present the sub-
stance that Congress intended in section 162.

A better perspective on this issue, however, may be derived from
the general teachings and approaches of the cases previously dis-
cussed. In general, courts have focused on statutory provisions and
found that the substance of the transaction did not comport with
the statutory intent.\textsuperscript{120} Of utmost importance is the courts' reliance
on the fact that the taxpayers were related by ownership.\textsuperscript{121}

\textsuperscript{114} See, e.g., Higgins v. Smith, 308 U.S. 473 (1940).
\textsuperscript{115} See, e.g., Crosby Valve & Gage Co. v. Commissioner, 380 F.2d 146 (1st Cir. 1967).
\textsuperscript{116} 308 U.S. at 474.
\textsuperscript{117} Id. at 475-76.
\textsuperscript{118} Deductible trade or business expenses are defined as "all ordinary and necessary ex-
\textsuperscript{119} penses paid or incurred during the taxable year." I.R.C. § 162(a).
\textsuperscript{120} See supra paragraph in text following note 15.
\textsuperscript{121} See supra notes 98-111 and accompanying text.

The cases discussed supra at notes 98-111 and accompanying text focused on transac-
tions involving related parties. The doctrine of substance over form is not so limited, how-
ever. See, e.g., Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966). There, an interest
deduction was denied because the court found that the whole transaction lacked any realistic
expectation of an economic profit. In reaching this conclusion, the court remarked: "[a] close question whether a particular Code provision authorizes the deduction of a certain
payers have argued that the doctrine of separate corporate entities requires the fact of ownership be disregarded, and that the substance of the transaction be examined on the basis of a presumption that the insurance contract was in reality between unrelated parties. In both *Higgins* and *Crosby Valve & Gage Co. v. Commissioner*, however, the fact of ownership was the only fact necessary for those courts' decisions. Thus, when analyzing the economic reality of transactions between related parties, a court need not ignore the essential fact of relation.

Captive insurance requires a somewhat different method of interpretation, however. *Gregory, Higgins, and Crosby Valve & Gage Co.* dealt with income tax terms: "reorganization," "loss sustained," and "charitable deduction." These concepts are statutory creations; they do not derive their meaning from any real world context. In the captive insurance arena, however, a court must measure the transactions being examined against tax provisions that draw their content from life. As noted before, tax law permits a deduction for insurance payments, but the term "insurance" is not defined in the Code or Treasury Regulations. "Insurance" is not a statutory term of art, but a term descriptive of an important aspect of economic life. An obvious conclusion would be that tax law would only allow a deduction for insurance premiums that satisfy accepted definitions of insurance.

An aspect of the real world is, of course, the legal form in which captive insurance is couched. Even in a legal context, however, it is recognized that insurance requires a transfer of risk. In determining whether a group health insurance plan was insurance regulated by the District of Columbia Code, the court in *Jordan v. Group Health Association* found that insurance required risk transfer.

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item is best resolved by reference to the underlying congressional purpose of the deduction in question." Id. at 741.


See supra text accompanying notes 40-41.

125 *Higgins*, 308 U.S. at 475; *Gregory*, 293 U.S. at 468-69; *Crosby Valve & Gage*, 380 F.2d at 147.

See supra text accompanying notes 40-41.

126 107 F.2d 239 (D.C. Cir. 1939) (opinion by Rutledge, J.).
Because the plan did not transfer risk, it was not insurance.\textsuperscript{127} In its opinion, the court considered the definition of insurance or of indemnity:

While the basic concepts are not identical and each has varied legal usages, they have common and primary elements which are controlling here. Fundamentally each involves contractual security against anticipated loss. Whether the contract is one of insurance or of indemnity there must be a risk of loss to which one party may be subjected by contingent or future events and an assumption of it by legally binding arrangement by another. Even the most loosely stated conceptions of insurance and indemnity require these elements. Hazard is essential and equally so a shifting of its incidence. \textit{If there is no risk, or there being one it is not shifted to another or others, there can be neither insurance nor indemnity.} Insurance also, by the better view, involves distribution of the risk, but \textit{distribution without assumption hardly can be held to be insurance.} These are elemental conceptions and controlling ones.\textsuperscript{128}

The Supreme Court has focused on similar characteristics in cases dealing with the question of what constitutes "business of insurance" within the meaning of federal antitrust laws.\textsuperscript{129} In this context, the Court considered the question of transfer and distribution of risk to be crucial to a determination of the existence of the "business of insurance."\textsuperscript{130}

\textbf{D. Taxpayer Arguments Based on Tax Principles and Governmental Response}

Though general theories of economics and insurance deny that captive insurance arrangements are insurance, tax law will not necessarily follow this position if it conflicts with tax law doctrine. Although ownership is sometimes taken into account under the doctrine of substance over form,\textsuperscript{131} the parameters of this approach present difficult questions in view of the doctrine of separate corporate entities. An examination of two principal arguments of taxpayers illustrate this problem.

\begin{itemize}
\item Id. at 245-47.
\item Id. at 245 (footnote omitted) (emphasis added).
\item \textit{Union Labor}, 458 U.S. at 127-28; \textit{Royal Drug}, 440 U.S. at 220-21.
\item See, e.g., supra notes 104-07 and accompanying text.
\end{itemize}
1. Taxpayers' First Argument

Taxpayers typically characterize a captive insurance transaction as an actual transfer of the financial consequences of risk to the captive insurer, and argue that the government is attributing risks that are now the risks of the captive insurer back to the shareholder-insured. The contention that the captives' risks are being attributed to the insured is supported in one analysis advanced in *Carnation Co. v. Commissioner.* In that case, the court looked at two principal agreements: first, the insurance contract purporting to shift the risk to Carnation's captive; and second, an agreement to the effect that the insured would provide additional capital to the captive (up to a total of $3 million) on request. The court viewed this combination as "neutralizing" the risk. The focus of risk neutralization is on the affairs of the captive, finding that the captive bears no overall risk because the insurance risk is offset by the ability to obtain additional funding from the insured. Therefore, from the insured's point of view, the insurable risk that it had rid itself of was offset by its investment risk in the captive. The court's theory, however, is an application of the sham doctrine, which is only the first level of inquiry into the substance of a transaction, and represents an understanding that the private intent of the parties was not congruent with the form of risk transfer in which the transaction had been clothed.

There are, however, certain limitations to this approach. First, there was no attempt in *Carnation* to determine as a factual matter whether the investment risk was actually equivalent to the insurance risk. Would an obligation to provide a little additional capital be sufficient as the basis for concluding that the parties' private intent was not to shift the risk? Second, since the guarantor represented an investment risk, it does not appear to be quali-

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133 Id. at 1012. There were actually three agreements viewed by the court, the third being the agreement with the fronting insurance company. This last agreement has been ignored in this analysis for reasons of simplicity.
134 Id. at 1013.
135 Id.
136 Although the Supreme Court in *Le Gierse* spoke in terms of risk transfer and risk distribution, that case could also be analyzed as a risk neutralization problem. *Helvering v. Le Gierse,* 312 U.S. 531, 539 (1941).
137 See *Carnation,* 640 F.2d at 1010-13.
tatively different from the risk borne by the captive’s owner with respect to the investment already put into the captive. For example, there appears to be no difference between putting $3,000,000 in the captive initially, and putting $120,000 in the captive initially and obligating oneself to put in an additional $2,880,000 if needed. This requirement can be easily circumvented, and courts after *Carnation* have found that its absence has no effect on the issue where 100% ownership is present.\(^{138}\) Indeed, although there was a guarantee in *Stearns-Roger Corp. v. United States*, both the district court and the Tenth Circuit ignored its presence in reaching their decisions.\(^{138}\)

Courts have essentially adopted the conclusions described above based on the characterization that in a captive insurance situation there is no validity to the transfer of the risks from insured to insurer,\(^{140}\) so there is no question of any attribution of the insurer’s risks. In other words, this characterization looks at the operations of the insured corporation and asks the question whether it has transferred the financial consequences of its own casualty risks which are attributable to its own business activities.

Different conceptual characterizations may appear to be mere semantic gamesmanship. Starting points are important, however, and this one is crucial to understanding this issue. To taxpayers, the issue is whether the captive insurance company is a viable insurance company following sound insurance practices. If so, the intercompany transactions are insurance from the perspective of the insurance company. The government and the courts, however, as-

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\(^{140}\) See, e.g., *Clougherty Packing*, 811 F.2d at 1305. The Ninth Circuit concluded that:

In reaching our holding, we do not disturb the separate legal status of the various corporate entities involved, either by treating them as a single unit or otherwise. Rather, we examine the economic consequences of the captive insurance arrangement to the “insured” party to see if that party has, in fact, shifted the risk. In doing so, we look only to the insured’s assets, i.e., those of Clougherty, to determine whether it has divested itself of the adverse economic consequences of a covered workers’ compensation claim. Viewing only Clougherty’s assets and considering only the effect of a claim on those assets, it is clear that the risk of loss has not been shifted from Clougherty.

Id.; see also cases cited supra note 1.
sume the existence of a valid insurance company.\textsuperscript{141} To them, the issue is whether the financial consequences of the insured's risks have been transferred to another.\textsuperscript{142}

This position is sounder. Since the question in these cases is whether the insured is entitled to a deduction for insurance, the proper focus should be on the insured. While the sham transaction doctrine might well focus on the validity of the insurance company as a corporate entity, the doctrine of substance over form looks squarely at the economic effect of the transaction on the taxpayer claiming the desired tax treatment.

2. **Taxpayers' Second Argument**

The second major prong of the taxpayers' attacks on the government's position is based on the way the tax law normally views intercompany transactions. When one focuses on transactions between related parties, one finds that many transactions—such as sales and loans—are normally respected for tax purposes.\textsuperscript{143} However, this is not always true. In the case of loans, for example, there are many cases which deal with the question of whether a transaction labelled a loan is, in fact, a capital contribution.\textsuperscript{144} Transactions between related entities are always subject to an examination to see whether the form chosen by the taxpayer comports with economic realities.\textsuperscript{145} The crucial difference between general related entity transactions and captive insurance transactions, according to the government's theory, is that the latter are never economically valid.\textsuperscript{146} This position is the heart of the captive insurance controversy.

Non-insurance transactions are essentially respected because they represent the division of the aspects of a business enterprise among related, but separate corporate entities. This approach com-

\textsuperscript{141} See, e.g., *Stearns-Roger*, 774 F.2d at 415.

\textsuperscript{142} See cases cited supra note 1.

\textsuperscript{143} See generally B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 1.05, 4.02 (4th ed. 1979).


\textsuperscript{145} See generally B. Bittker & J. Eustice, supra note 143, ¶ 1.05, 4.02.

ports with the policy behind allowing taxpayers to avail themselves of the recognized form of corporate or multiple corporate enterprise.\textsuperscript{147} Since transactions are respected as long as they are bona fide, it is obvious that the tax attributes of the transaction must follow. For example, where property is sold to a related corporation, all the tax consequences of profit or loss follow because the transferee becomes the owner and the bearer of the risks associated with that property. Thus, an uncertain casualty risk can be transferred for tax purposes to a related entity so long as that transfer is subsumed in a bona fide transfer of the asset,\textsuperscript{148} because the transferee bears all of the benefits and burdens of ownership.

The government argues, however, that an economic enterprise cannot place its entire casualty risk exposure in an arm of the enterprise and have that action respected for tax purposes.\textsuperscript{149} In that case, the taxpayer is trying to separate the financial consequence of the pure risk of casualty loss that is an attribute of its business activity. According to the government, the only recognized form of accomplishing such a separation is insurance, which cannot be effectuated between parties related by ownership.\textsuperscript{150} To better understand the government's position, the theory underlying it will now be examined in detail.

If one examines pure risk, rather than the financial consequences of the risk, one can readily see that a corporation can never transfer pure risk to another, unless the corporation transfers the business activity or property that occasions the risk. It would be a significant business achievement if a business enterprise could place all of its exposure to the casualty risks or liabilities in another corporation and thereby limit its liability to the amount of its investment in that other corporation. But a corporation always remains liable for the risk exposure occasioned by the business it operates.

The only recognized way of separating the financial conse-

\textsuperscript{147} See supra notes 80-83 and accompanying text.
\textsuperscript{148} See Rink v. Commissioner, 51 T.C. 746 (1969); Sas-Jaworsky v. Commissioner, 24 T.C.M. (CCH) 630 (1965), aff'd per curiam, 379 F.2d 337 (5th Cir. 1967). The courts determined that it was the corporate property owners, not the shareholders, that were entitled to casualty or other loss deductions with regard to the corporations' properties used in its businesses.
\textsuperscript{149} Brief for the United States at 70, Mobil, 8 Cl. Ct. 555 (No. 358-78) (copy on file).
\textsuperscript{150} Id.
quences of risk exposures from the risk exposures themselves is through the risk transfer device of insurance. When dealing with a related insurance affiliate, however, the insured corporation cannot say that its financial risk, and therefore its potential loss, are limited by the transaction.\textsuperscript{161} Nor can it say that its financial exposure is limited to its investment in a separate corporate entity, its insurance affiliate; on the contrary, its exposure to financial loss is independent of its investment. Indeed, the more capital the enterprise puts in its insurance affiliate, the more likely that capital will be consumed in making good the actual financial losses; the less capital the enterprise puts in its insurance affiliate, the more likely that the insurance affiliate will be unable to make good on the actual financial losses.

The taxpayers' characterization of the government's argument as dependent on the concept of risk neutralization\textsuperscript{162} is incorrect. Where a parent sells property to its subsidiary and receives payment, it has practically separated this property from its business. Indeed, the parent still has an interest in the property, but this is solely an investment interest in the subsidiary. This transfer can have significant practical implications, for example, if the use of this property by its subsidiary caused injury to third parties. While the subsidiary would be liable for the damages caused, the parent would only be liable normally insofar as its investment is at risk. On the other hand, if the parent retains the property and the casualty occurs, where the parent insures with its captive, the parent's loss exposure is not limited to its investment in its captive.

While a sale between related entities carries with it an actual physical transfer of property and its consequences, insurance is based on the transfer of the financial consequences of pure risk. Insurance is different from a sale or other transactions and is unique because the transaction can only be understood in financial terms. In addition, insurance deals solely with the downside of business activities. There is no benefit from having a casualty risk related to one's business; either a loss does not occur or, if it occurs, the consequences are always negative. This is quite unlike other business activities, because other activities provide the opportunity for profit in addition to a risk of loss.

\textsuperscript{161} See supra notes 15-17 & 64-66 and accompanying texts.

\textsuperscript{162} See supra note 136 and accompanying text.
Insurance is therefore unique in that it is the mechanism for transferring a feature of business which has only negative implications. When a business has obtained insurance, it has quite clearly separated these negative financial implications from its operations. However, when a corporation retains the risk either directly or through its insurance affiliates, the corporation has not separated these negative financial implications from its operations.

Courts have agreed with the government's position on the captive insurance issue based on the practical and theoretical concepts discussed above. In fact, the Mobil court stated: "Insurance is a unique risk transfer device. Other situations involving transfers between related corporations which are acceptable for tax purposes are not relevant [to the insurance situation]."153

V. CAPTIVE INSURANCE AND UNRELATED PARTIES

The focus of the issue so far has been on situations where a parent company (or its affiliates) insures with a captive that is 100% owned. In this situation, courts have focused on one element of the definition of insurance, risk transfer, and have found it to be lacking.

However, third parties, which are unrelated to the insured by stock ownership, may be involved in the situation. An appropriate question to be examined at this point is the effect of this involvement on captive insurance arrangements. Two separate third party situations will be analyzed: third-party involvement in ownership of the captive insurance company; and, third-party insureds of the captive insurance company.

A. Third-Party Ownership

As a general proposition, a party who enters into a contract of insurance with an unrelated insurance company has shifted the risk of loss to another.154 If, however, the unrelated insurer acts as a fronting company and reinsures part or all of the risk with the insured's captive, the agreements of insurance and reinsurance will be viewed together.155 To the extent that the captive reinsures the

153 8 Cl. Ct. at 564.
154 See supra note 64 and accompanying text.
155 See, e.g., Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir.), cert. denied, 454
insured's risks, there will be no risk transfer. Under Revenue Ruling 77-316 and the court cases, however, insurance exists when the risk is retained by an unrelated fronting company or is reinsured by the captive with an unrelated insurer.\(^{156}\)

What happens, however, when the captive is only partially owned by the insured and the balance is owned by interests unrelated to the insured by stock ownership? This question was not addressed in the Service's original position on captive insurance in Revenue Ruling 77-316. Only two cases to date have dealt with captive insurers where outside ownership was present.\(^{157}\) In *Beech Aircraft*, the district court recognized the presence of outside ownership, but found the unrelated owners' participation in the insurance program to be insignificant.\(^{158}\) It is apparent from the rest of the opinion that the court viewed the captive as wholly-owned by Beech Aircraft.

The second case to deal with this factual situation was *Crawford Fitting Co. v. United States*,\(^{159}\) which was decided in favor of the taxpayer. In *Crawford Fitting*, the insured corporate taxpayer (Crawford) did not have a direct ownership interest in the insurance company. Crawford was wholly-owned by an individual (Lennon) who had varying partial ownership interests in four corporations which together had an 80% ownership interest in an insurance company (Constance). The balance of the four corporations was owned by Lennon's wife and daughter.\(^{160}\) The remainder

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\(^{156}\) See *Carnation*, 640 F.2d at 1013; *Mobil*, 8 Cl. Ct. at 567-68; Rev. Rul. 77-316, 1977-2 C.B. at 53.

\(^{157}\) Two articles have suggested that the *Mobil* case also dealt with a partially-owned captive. See Fogarisi & Renfroe, *Deductibility of Payments to Captive Insurance Companies Revisited But New Questions Raised—Mobil Oil Corporation v. United States*, 14 Tax Mgmt. Int'l J. 358, 361 (1985); Bradley & Winslow, supra note 18, at 243 n.88. This characterization, however, is incorrect. One of Mobil's four captives, Westchester Insurance Company, Ltd., was acquired by Mobil in 1962. Prior to its acquisition, Westchester had been a subsidiary of Standard-Vacuum Oil Company, which had been owned jointly by Mobil and Standard Oil Company of New Jersey. The *Mobil* case did not involve Westchester prior to its acquisition by Mobil. See 8 Cl. Ct. at 563.

\(^{158}\) Beech Aircraft Corp. v. United States, 1984-2 U.S. Tax Cas. (CCH) ¶ 9803, at 84,401 (D. Kan. 1984). In *Beech Aircraft*, the district court found that 11,000 shares out of the 120,000 outstanding of the captive were owned by "six other concerns or individuals, most of whom were affiliated with Beech." Id.


\(^{160}\) Id. at 137.
of Constance (20%) was owned by individuals who were not related to Lennon, but who had a business relationship with the taxpayer Crawford. Thus, Lennon, the 100% owner of Crawford, owned indirectly (by virtue of his ownership interest in the four corporations) 44.02% of the insurance company.\textsuperscript{161}

The court noted that the different ownership relations were crucial to whether the taxpayer had obtained insurance and found "that the taxpayer and the other shareholders of the captive insurance company, as well as the insureds, are not so economically related that their separate financial transactions must be aggregated and treated as the transactions of a single taxpayer, the plaintiff."\textsuperscript{162} After examining the ownership relations outlined above, the court found "these above related alterations of fact to be so significantly different from the situations set forth in the above cited cases and in Revenue Ruling 77-316 that they change the characterization of the 'insurance premiums,' and the tax treatment accorded them, in those cases and that ruling."\textsuperscript{163}

Statements in the court's opinion suggest several different conclusions about the legal significance of the ownership factor in determining whether an insurance relationship has been established. Recognizing that the corporate taxpayer was not the parent of the insurance company nor the owner of other corporations that owned the insurance company could lead to the conclusion that only affiliated groups of corporations are affected by this issue.\textsuperscript{164} This would mean that where individual A insures with his wholly-owned corporation X, then insurance and risk transfer would occur. Obviously, the economic analysis is not so limited.\textsuperscript{165}

The more important conclusion in Crawford Fitting is that the court considered the insurance company to have been essentially owned by different individual taxpayers whose interests could not be aggregated for purposes of the economic analysis. This was a

\textsuperscript{161} Id. at 137-138. A Canadian captive insurance case considered a similar ownership pattern. See Bonavista Cold Storage Co. v. M.N.R., [1983] C.T.C. 2093 (Tax Rev. Bd.).

\textsuperscript{162} 606 F. Supp. at 145.

\textsuperscript{163} Id. at 146.

\textsuperscript{164} Id. at 146-47.

\textsuperscript{165} See Higgins v. Smith, 308 U.S. 473 (1940). Without expressing an opinion on the correctness of the reasoning or result in Crawford Fitting, the Ninth Circuit indicated that this distinction between corporations and individuals "may seem artificial." Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1304 (9th Cir. 1987).
rejection of the government’s position that relied on an expanded
view of an economic family including human and corporate coun-
terparts.\textsuperscript{166} The court’s rejection of the government’s attribution
argument is understandable, since the government did not provide
any statutory or non-statutory authority for its position.\textsuperscript{167}

The court’s view of the ownership factor in \textit{Crawford Fitting} is
analogous to the Service’s position in Revenue Ruling 78-338, upon
which the Court relied.\textsuperscript{168} In that Ruling, the Service reviewed a
situation in which there were thirty-one owner-insureds, including
the taxpayer. Because no owner had a controlling interest in the
insurer, or individual risk coverage in excess of five percent, the
Service found that the premiums paid by the taxpayer were de-
ductible ordinary and necessary business expenses under section
162.\textsuperscript{169}

In comparing the situations involved in \textit{Crawford Fitting} and
Revenue Ruling 78-338, there are some important distinctions not
recognized by the court. In \textit{Crawford Fitting}, Lennon’s direct and
indirect ownership interests were 100% of Crawford, and 44% of
Constance, without attributing to him the indirect ownership of his
spouse and daughter, which accounted for another 36% of Con-
stance. Forty-four percent is not a controlling interest as a matter
of numbers, but on reviewing the facts, Lennon owned controlling
interests (more than 50%) in three corporations that owned 60% of
the stock of Constance.\textsuperscript{170} Thus, Lennon, the sole owner of the
taxpayer, had practical control over the insurer, even without attri-
bution of the ownership interests of other members of his family.

\textsuperscript{166} 606 F. Supp. at 141.

\textsuperscript{167} See I.R.C. § 267. Section 267 is an example of a Code-based attribution rule for the
purpose of postponing or denying deductions for transactions between related parties. Sec-
tion 267 applies to losses from the sale or exchange of property between related parties and
the timing of provisions for expenses incurred between related parties. The objective of the
timing provisions is to defer deductions until the income is included by a related person. In
a captive insurance arrangement the premium payment could represent unearned premium
income to the insurer. The language of the Code, however, speaks of a situation where the
amount “is not (unless paid) includible in the gross income of such person.” I.R.C.
§ 267(a)(2)(A). In a captive insurance scenario, however, the premium is not excluded from
income because it has not been paid (because it has), but because of special features of
insurance accounting. See supra notes 28-32 and accompanying text. Thus, § 267 does not
appear to apply to captive insurance arrangements.

\textsuperscript{168} See 606 F. Supp. at 146.


\textsuperscript{170} 606 F. Supp. at 137-38.
The court nevertheless concluded that the transactions were insurance in their totality. While the positioning of the line drawn by the court greatly differed from that of the Service, this view was consistent with the all-or-nothing approach taken in Revenue Ruling 78-338. The government in Crawford Fitting had similarly advocated an all-or-nothing approach.

Neither approach is entirely satisfactory, however. The error in both approaches is that the concept of economic family is no more than a question of ownership, and that the presence of insurance depends on actual risk transfer. Viewing the ownership criterion as a matter of economics, risk has been retained and risk transfer has not been accomplished to the extent that the insured owns or constructively owns the insurer. Just as important, however, is the fact that risk has not been retained and risk transfer has been accomplished to the extent that the insured does not own or constructively own the insurer, and the unrelated ownership of the insurer is bona fide. Bona fide ownership requires the unrelated owners to be risking their proper percentage of capital in the enterprise, and there must be sufficient capital in terms of the risks borne by the insurance company.

The court's and the government's approach in Crawford Fitting views the insurance contract as a unit, and insurance depends on whether the risk has been essentially transferred. This unitary approach is not consistent with other cases. In other cases, where the risk is subdivided among insurance companies, the insurance contract is broken into parts. Thus, where the risk is insured with an unrelated fronting company, reinsured with a wholly-owned captive, and reinsured with an unrelated insurance company, the contract is treated as insurance to the extent and only to the extent a portion of the risk (and the premium) is retained by wholly unrelated parties. There is no reason why this approach, based

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171 Id. at 145.
172 The Service's Chief Counsel recommended that no appeal be initiated in Crawford Fitting because the record did not disclose that Lennon had de facto ownership of the interests of his wife, daughter, employees, and the outside attorney. Furthermore, the record suffered "from the absence of expert opinion evidence regarding the meaning of 'insurance.'" Action On Dec. CC-1986-007, Crawford Fitting Co. v. United States (Jan. 8, 1986). This view is in keeping with the following analysis.
173 See supra note 155.
174 See supra note 155.
on a consistent and correct view of risk retention and risk transfer, should not be applied to the Crawford Fitting situation of partly-owned captives. The proper and consistent approach should be that insurance is not created to the extent of the percentage of ownership by the insured of the insurer.

But the application of this approach is not entirely free from judgment calls. There may be a point at which the insured-owner’s ownership interest is so small that it is not administratively practical to bifurcate the transaction into insurance and risk retention. In that situation, the insurance policy should be viewed as being insurance in its entirety. Owner-insureds of mutual insurance companies exemplify this problem and its resolution. The question remains as to how much partial ownership will trigger the proper approach discussed above.

The line-drawing problem in this situation essentially involves the self-imposed administrative or judicial limitations on the doctrine of substance over form. Revenue Ruling 78-338 provides a rough answer to this question. In that Ruling, the Service suggested a limitation on the resort to the substance over form analysis in this context, based on factors such as the number of owner-insureds, the percentage of each insured’s portion of the entire risk of the insurance company, and the absence of control by any insured. This Ruling provides that these factors should guide the Service in deciding to stop examining the substance of the insurance arrangements based solely on the principles of ownership.

B. Third-Party Insured—Risk Transfer and Risk Distribution

To examine the effect of third-party insureds of the captive insurance company on the concept of insurance, one must begin with the concept of risk distribution. According to the Le Gierse analysis, risk distribution, or risk pooling, is an essential element of an insurance arrangement. Obviously, risk distribution is the essence of the practical way insurance companies handle their exposures to retained risk.

Where a captive insurer accepts and retains risks of parties unrelated to the economic family, it could be said that risk distribu-

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tion should be effectuated as a matter of federal tax law. Risk distribution, however, is only one element of the definition of insurance. The crucial issue involving third-party insureds is whether the presence of third-party risks retained by the captive converts the relation between parent and captive into insurance. That is, does risk distribution effectuate risk transfer?

The question of risk distribution has not been of much importance in reported cases. Although Revenue Ruling 77-316 found that risk distribution is not present where the captive insurer solely insures the risks of the economic family, no majority opinion has yet dealt with that issue, since the courts have focused solely on risk transfer. To date, only three reported cases have involved the presence of third-party insureds in a situation where the captive insurer was 100% owned, and none of the courts found this factor significant.

The typical fact pattern in these cases involved insureds who had a business relation to the economic family and the economic family paid the premium for the coverage. In Stearns-Roger, the taxpayer was required by contract to insure project customers, in Humana, the taxpayer insured employee-doctors, and in Mobil, the captives insured third parties in various situations. In

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178 A concurring opinion in Clougherty Packing Co. v. Commissioner viewed the parent company as having transferred its risks, but found that risk distribution was not present where the only insured was the parent of the captive. 84 T.C. 948, 963 (1985) (Hamblen, J., concurring).

In Bonavista Cold Storage Co. v. M.N.R., a Canadian case cited previously, the Tax Review Board found adequate risk distribution on the basis of the number of risks insured even though all of the risks borne by the captive were those of one corporate taxpayer. See [1983] C.T.C. 2093, 2110 (Tax Rev. Bd.).

180 577 F. Supp. at 834.
182 8 Cl. Ct. at 561-62. According to the Claims Court:

These parties included: "parties that had a business relationship with a Mobil company," "corporations which were owned in part by parties unrelated, directly or indirectly, to Mobil by stock ownership," "unincorporated ventures in which a Mobil affiliate and one or more parties unrelated by stock ownership to Mobil were participants," "builders all risk policies issued in the names of Mobil affiliates and the affiliate's contractors," "insurance or reinsurance covering property belonging to employees of Mobil and its affiliates," "marine cargo shipments for the account of
Stearns-Roger and Humana the courts apparently did not regard the business as a true unrelated business or unrelated independent risks, for in Stearns-Roger the trial court found that the captive was not engaged in the business of insuring others, and in Humana the court found that the coverage "was clearly an integral part of the protection of the parent corporation" and its subsidiaries.

In Mobil, however, one captive insurer truly issued third-party insurance. Bishopsgate Insurance Co., Ltd. ("Bishopsgate") was an insurance company acquired by Mobil long after its incorporation. Bishopsgate had issued, and continued to issue, policies to unrelated parties. In fact, during most of the pertinent years, third-party insurance represented the majority of Bishopsgate's business in terms of risks insured and retained by that company.

Most of Bishopsgate's Mobil risks were those of Mobil's foreign affiliates. These risks were predominantly reinsured with either Mobil's Bahamian captive, General Overseas Insurance Co. ("GOIC"), or its Bermuda captive, Bluefield Insurance, Ltd. ("Bluefield"). It was GOIC and Bluefield that reinsured the risks of Mobil's U.S. affiliates. Moreover, according to the government's brief, the only genuine third-party business undertaken by GOIC and Bluefield was the reinsurance of some of the unrelated party risks of Bishopsgate, which amounted to approximately 1.1% of earned premiums for the former two companies.

unrelated parties where Mobil Oil was selling the products shipped," "premiums ceded by Bishopsgate to GOIC and Bluefield that were attributable to fire insurance and fire reinsurance written by Bishopsgate."

Id.

183 577 F. Supp. at 838.
185 8 Cl. Ct. at 562-63.
186 Id. at 556 n.1. In Plaintiff's Requested Findings of Fact, essentially unobjectioned to by the government, the plaintiff alleged that "the percentage of Bishopsgate's total net earned premiums that was attributable to . . . unrelated parties was at least 60% in 1964, and exceeded 50% in 1965, 65% in 1966, 90% in 1967, and 90% in 1968." Plaintiff's Requested Findings of Fact at No. 155, Mobil, 8 Cl. Ct. 555 (No. 358-78) (copy on file); Defendant's Objections to Plaintiff's Requested Findings of Fact at 46 (copy on file).
187 8 Cl. Ct. at 561-62. The insurance issue in Mobil only affected Mobil's foreign affiliates to the extent that the government contended that the premium payments were a constructive dividend to the parent corporation. The issue was resolved by the court in favor of the taxpayer. See supra note 15.
188 Brief for the United States at 90.
The court in Mobil did not discuss the effect of third-party business, other than as a factual matter, even though the issue was briefed in considerable detail by the parties.\textsuperscript{189} The court found that risk transfer was lacking and that "[i]nsurance through a wholly-owned insurance affiliate is essentially the same as setting up reserve accounts."\textsuperscript{190} Thus the court apparently viewed risk transfer as non-existent, irrespective of the presence of third-party insureds.\textsuperscript{191}

In contrast to the cases discussed immediately above, Crawford Fitting Co. v. United States dealt not only with third-party ownership but also with third-party insureds. In Crawford Fitting, the court found that risk transfer had been accomplished because of the differences in ownership, and that risk distribution was effectuated by the insurance company by combining the risks of the taxpayer-insured with the risks of unrelated parties.\textsuperscript{192} The court held that "the plaintiff did shift the risk of loss outside its economic family to the captive, who fairly and adequately distributed the risk of loss among its group of insureds."\textsuperscript{193} Therefore, it is apparent that the Crawford Fitting court treated risk transfer and risk distribution as separate concepts.

Informal opinions of the Service imply that an insurance transaction can be effectuated between 100%-owned affiliated companies where the affiliated insurance company also accepts "substantial" insurance risks of unrelated parties,\textsuperscript{194} but these opinions never define what constitutes "substantial" unrelated business.\textsuperscript{195}

\textsuperscript{189} See Plaintiff's Post-Trial Brief at 44-51; Brief for the United States at 73-91.
\textsuperscript{190} 8 Cl. Ct. at 567.
\textsuperscript{191} Accord Bradley & Winslow, supra note 18, at 242. It is also possible that the Claims Court viewed the reinsurance of the unrelated risks of another captive as related risks. As noted, according to the government's position these were the only genuine unrelated risks distributed with Mobil's U.S. corporations' risks. See supra note 188 and accompanying text.
\textsuperscript{193} Id.
\textsuperscript{195} All that is really known about the Service's concept of "substantial" is that 3\% of unrelated party business is not substantial and that 51\% of unrelated party business may not be substantial. See Priv. Ltr. Rul. 7,904,047 (3\%); Priv. Ltr. Rul. 8,215,066 (51\%).
These opinions are based on the thought that substantial combinations of the risks of affiliated corporations with those of unrelated parties (risk pooling) within a wholly-owned insurance affiliate effectuates the transfer of the economic family's risks outside the group. In other words, risk distribution can effectuate risk transfer.

The Service, in two publications, has indicated doubts as to its own informal opinions. In Revenue Procedure 82-41, the Service announced that it would not issue determination letters in this area unless the facts of the transaction were within the confines of Revenue Ruling 77-316, or Revenue Ruling 78-338. Furthermore, in General Counsel Memorandum 39,247 the Service withdrew a previous Memorandum that had indicated that a parent could shift and distribute risk if forty to fifty percent of the captive's premiums were from unrelated parties. In withdrawing the earlier Memorandum, the Office of Chief Counsel stated:

> Because our [previous] conclusion . . . is not consistent with the position ultimately adopted by the Service, . . . [it] is revoked. The captive insurance issue is now the subject of litigation in the United States Claims Court in Mobil Oil . . . and we will defer further comment on this issue until that litigation is concluded.

In the Mobil litigation, the U.S. Department of Justice clarified this issue. The government asserted that the presence of third-party insureds has no effect on the question of whether the economic family has obtained insurance with its captive. The view is that risk transfer and risk distribution are two distinct, independent principles as a matter of insurance theory.

The cases discussed above do not explain the logic behind the distinction between risk transfer and risk distribution or why the Service's informal opinions are incorrect in the captive insurance setting. But the fallacy of the informal opinion position can easily

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197 Id.
199 Id.
200 Brief for the United States at 74. The government's position in Mobil conflicted with prior informal opinions issued by the Service. See supra notes 194-95 and accompanying text. The government could adopt this conflicting view because, even though informal Service opinions are of public record, by statutory command they are given no precedential value. See I.R.C. § 6110(j)(3).
be exposed. The statement that the economic family has shifted its risk outside the family to unrelated policyholders when its captive insures unrelated parties is simply nonsensical. The risks of the economic family are still retained by a subsidiary of the enterprise; unrelated policyholders have shifted their risks to the captive, not the other way around, because the unrelated policyholders have received a contract of insurance from the captive that relieves them of the financial uncertainty of their own risks and fixes the amount of their potential losses at the amount of the premium. The captive, by accepting the risks of unrelated parties in addition to the risks of its economic family, bears a larger number of risks. Indeed, when one considers the financial impact on the economic family with respect to its own risks, there is absolutely no difference whether its captive accepts the risks of unrelated parties or only handles its affiliates' risks.\textsuperscript{201}

The theory that risk distribution effectuates risk transfer is based on the mistaken view that the premiums of the unrelated policyholders will somehow pay for the risks and claims of the economic family. To believe that this could happen in the long run supposes that unrelated policyholders will consent to consistent overcharging for the coverage that they obtain. And, of course, overcharging unrelated parties would result in a profit which the captive would use to pay its own economic family's claims.\textsuperscript{202} However, in reality, it is just as likely that the premiums of the economic family will be used to pay the claims of the unrelated parties.\textsuperscript{203}

The informal opinion position is also based on the concept that, by taking on the risks of unrelated parties, the risks borne by the parent are reduced. This theory is the result of a misunderstanding of risk distribution as a matter of insurance and economic theory, and is not supported by any theoretical analysis.\textsuperscript{204} Because of its

\textsuperscript{201} See supra notes 8-17 & 60-72 and accompanying texts.

\textsuperscript{202} See Greene, supra note 16, at 254.

\textsuperscript{203} Id. See, e.g., Captives Share Sour Underwriting Loss, Bus. Ins. 22 (Apr. 6, 1981).

\textsuperscript{204} Risk distribution is a function of the quantity and quality of the risks accepted and retained by the insurance company. The pooling of a large number of independent but similar hazards brings into play the law of large numbers. While pooling increases the predictability of the range in which the average loss will fall (the average loss being the total loss over the number of policies), it also increases the total loss, decreases the predictability of the total loss, and increases the probability of total disaster (a situation where total losses exceed premiums and capital). This is the risk that the insurance company and its investors
ownership and investment, the economic enterprise of affiliated corporations bears the financial consequences of not only its own losses, but of those of unrelated parties that its captive insures. The only crucial difference between insuring oneself and adding third parties is that the captive has entered into the insurance business with respect to those third parties and receives a premium in return for its bearing the financial consequence of the uncertain losses, and the captive must commit additional capital or surplus to do so.\textsuperscript{205} But as far as the parent company's stockholders are concerned, the financial condition of a company with self-insurance and an insurance affiliate insuring third parties would be essentially the same (disregarding tax consequences) as if the same company used captive "insurance" with unrelated party business,\textsuperscript{206} whereas the financial condition of that same company with

\textsuperscript{205} The capital and surplus (which represents profits earned by the company in prior years) of an insurance company supplies a buffer against a situation where total losses exceed premiums. It should come as no surprise, therefore, that the amount of capital of an insurance company is a crucial element in determining the amount of business it is permitted to underwrite under state regulatory provisions. Accordingly, the capital of an insurance company is highly regulated by states. See, e.g., N.Y. Ins. Law §§ 107, 108, 1115, 1310, 4103 (McKinney 1985). Indeed, there is a direct relationship between the risks that an insurance company underwrites and its capital and surplus. Under the guidelines of the National Association of Insurance Commissioners ("NAIC"), the ratio of premiums to surplus and capital is the first test for determining the financial well-being of an insurance company. See Using the NAIC Insurance Regulatory Information Systems, Property/Liability Ed. 1982 (Jan. 1983). Congress has recognized these principles by allowing investment income of one-third of earned premiums to escape Subpart F treatment for the following reasons:

In order to write insurance and accept reinsurance premiums, foreign insurance companies may be required by the laws of various jurisdictions in which they operate to meet various solvency requirements in addition to specified capital and legal reserve requirements. Many jurisdictions also employ an internal rule-of-thumb as to what the ratio of surplus to earned premiums should be. In the United States, the National Association of Insurance Commissioners employs a ratio of 1 to 3 (surplus to earned premiums) as the guideline by which State regulatory agencies can measure the adequate solvency of companies insuring casualty risks. If such a company's ratio were less than 1 to 3, for instance 1 to 4, the State regulatory agency may question its ability to accept additional risks. Surplus maintained in compliance with the 1 to 3 ratio, although not necessarily required by law, has been considered as ordinary and necessary to the proper conduct of a casualty insurance business in the United States. Staff of Joint Comm. on Tax'n, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 231 (1976). But see infra text following note 225.

\textsuperscript{206} As far as the economic family's stockholders are concerned, the fortunes of the group
insurance provided by unrelated insurance companies would be markedly different.

Thus, risk distribution in itself can never effectuate risk transfer.\textsuperscript{207} Risk is not reduced by distribution; it is reduced by transfer.\textsuperscript{208} The addition of risks leads to a larger potential, and less certain, liability. Thus, it is not by pooling risks, but by subdividing risks, that one reduces risk potential.\textsuperscript{209} Because risk transfer is

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and its captives are reported under the Accounting Practice Board requirements on a consolidated or equity basis, and its “insured” losses (or lack thereof) have a direct impact on its financial condition. See supra note 68 and accompanying text.

\textsuperscript{207} Distribution is not transfer; distribution by itself does not effectuate an essential element of insurance. This was pointed out by Judge Rutledge in Jordan v. Group Health Ass’n, 107 F.2d 239, 245 (D.C. Cir. 1939); see supra text accompanying notes 126-28.

\textsuperscript{208} As Samuelson pointed out:

In short, it is not so much by adding new risks as by subdividing risks among more people that insurance companies reduce the risk of each. To see this, do not double or change at all the original number of ships insured by the company; but let each owner sell half his shares to each new owner. Then the risk of loss to each owner per dollar now in the company will have indeed been reduced.

Undoubtedly this is what my colleague really had in mind. In refusing a bet of $100 against $200, he should not then have specified a sequence of 100 such bets. That is adding risks. He should have asked to subdivide the risk and asked for a sequence of 100 bets, each of which was 100th as big (or $1 against $2). If the money odds are favorable and if we can subdivide the bets enough, any expected-utility-maximizer can be coax ed into a favorable-odds bet—for the obvious reason that the utility function’s curvature becomes more and more negligible in a sufficiently limited range around any initial position. For sufficiently small bets we get more-than-a-fair game in the utility space, and my basic theorem goes nicely into reverse.

Secondly, and finally, some economists have tried to distinguish between risk and uncertainty in the belief that actuarial probabilities can reduce risk to a “virtual” certainty. The limit laws of probability grind fine but they do not grind that exceeding fine. I suspect there is often confusion between two similar-sounding situations. One is the case where the owner of a lottery has sold out all the tickets; the buyers of the tickets then face some kind of risky uncertainty, but the owner has completely cancelled out his risks whatever the draw may show—which is not a case of risk as against uncertainty, but really reflects a case of certainty without any risks at all. Another case is that in which the management of Monte Carlo or of the “numbers game” do business with their customers. The management makes sure that the odds are in their favor; but they can never make sure that a run of luck will not go against them and break the house (even though they can reduce this probability of ruin to a positive fraction).

P. Samuelson, supra note 204, at 157.

\textsuperscript{209} Even though a risk may be unique, it can still be transferred as a practical matter if the risk can be divided among several or many owners. The insurance does not make the loss any less likely to happen, but, by dividing the risk, the insurer-owners have reduced their percentage of the financial consequences of the total risk to a level which is bearable. Captives generally obtain reinsurance from unrelated companies, recognizing that they too need a bona fide transference of risk to another.
essential to separating the financial risk of loss from the loss itself, the courts are correct in rejecting the Service's informal opinions, even though the analysis presented in the court opinions discussed above is fairly superficial. The Service is also correct in abandoning the analysis in its informal opinions and treating risk transfer and risk distribution as independent principles. This analysis leads to the correct result that the presence of third-party insureds, without more, does not change the underlying economic reality of captive insurance.\footnote{With regard to the government's present position on third party business, one loose end should be examined. A standard similar to the opinion expressed in the Private Letter Rulings is employed in the Treasury Regulations under § 105.

Section 105(b) of the Code excludes certain employee accident and health benefits paid by employers from the income of the employees. See I.R.C. § 105(b). Section 105(h) imposes certain conditions on self-insured plans, namely that the benefits of § 105 not be available to plans which discriminate in favor of highly compensated employees. See I.R.C. § 105(h).

Congress believed that a self-insurance arrangement provided greater opportunity for disproportionate compensation for highly compensated employees, so it imposed additional requirements on these plans. Thus, according to the Senate Finance Committee:

The bill applies only to an uninsured medical reimbursement plan, that is, a plan (or a portion of a plan) under which benefits are not provided by a licensed insurance company. Because underwriting considerations generally preclude or effectively limit abuses in insured plans, the committee does not regard the bill as a precedent for the treatment of insured health or accident plans.


The pertinent regulations specifically provide that a plan "that does not involve the shifting of risk to an unrelated third party is considered self-insured for purposes of this section." Treas. Reg. § 1.105-11(b)(ii). A plan written by a captive insurance company "is not considered self-insured for purposes of this section" where 50% or more of the premiums are derived from unrelated parties and the policies provided to the employees are similar to those sold to the unrelated parties. Treas. Reg. § 1.105-11(b)(iii).

It is apparent that § 1.105-11(b)(iii) of the Regulations is an exception created under the legislative rulemaking authority granted in § 105(h)(9) of the Code and is not a formal pronouncement that a plan in compliance with this Regulation is actually insurance. It is clear from the legislative purpose underlying the requirement in the Regulations that the Treasury has concluded that the presence of over 50% of a captive's business derived from similar contracts issued to unrelated parties promotes the supremacy of underwriting considerations and reduces the potential for abuse. Were the Regulation understood as a formal pronouncement on what is insurance, there would be no reason for requiring that employees' policies be similar to those sold to unrelated parties. If an arrangement is considered to
VI. Code-Based Approaches to the Captive Insurance Problem

A. Subpart F of the Internal Revenue Code

Subpart F of the Code taxes certain income derived from the conduct of an insurance business to United States shareholders of foreign insurance companies. The application of these provisions depends upon the characterization of captive insurance as insurance and of the captive insurance company as an insurance company for federal income tax purposes. In *Carnation Co. v. Commissioner*, the Ninth Circuit specifically held that Subpart F did not apply since none of the transactions involving the captive in-

be insurance because of unrelated party business, then an argument can easily be made that the Regulation's requirement of similar policies is invalid, or at least superfluous.

Assuming, arguendo, that the Regulation presents a valid exercise of administrative authority, what is its effect on the deductibility of premiums paid to a captive insurance company? It should have none. Under § 105, self-insured plans are not denied special treatment unless they fail to meet certain conditions. The problem addressed by § 105 is not whether a plan is self-insurance or insurance, but whether there is potential to use the plan to provide tax-free compensation on a discriminatory basis. Captive insurance that covers substantial outside risks and is issued to unrelated parties may eliminate this problem of abuse as well as true insurance.

Section 162 is the provision under which the deductibility or nondeductibility of captive insurance premiums should be addressed. The abuse perceived by courts and tax administrators is simply that taxpayers are attempting to deduct what is in reality self-insurance. The economic reality or unreality of captive insurance is not affected by the presence of unrelated party risks.

Thus, if a corporation that owned a major insurance company chose to "insure" with this insurance company, the transactions would not be insurance, even if the majority of the insurance company's business was with unrelated parties and the parent company's risks were a small part of the total risks of the insurance company. Such a transaction would merely represent a risk retention device, a fact well understood by corporate executives.

Only United States shareholders who own 10% or more of the voting stock of corporations that are controlled foreign corporations are subject to Subpart F. See I.R.C. § 951(a)-(b). Generally, a controlled foreign corporation is one in which more than 50% of the voting power of all the voting shares is owned by United States shareholders. See I.R.C. § 957(a).

A special rule includes certain insurance companies as controlled foreign corporations where 25% or more of the voting power or value of all classes of stock is owned by United States shareholders and more than 75% of the gross amount of all premiums is derived from insurance as defined in § 953(a)(1) of the Code. See I.R.C. § 957(b); see also infra note 225 and accompanying text.

This would be for the purpose of determining whether the product was insurance under the statute. See I.R.C. § 953(a).

This would be for the purpose of the pre-1987 special limitations on the inclusion of insurance company investment income. See I.R.C. § 954(c)(3); see also infra notes 226-30 and accompanying text.
Taxpayers have argued that Subpart F was meant to deal with captive insurance arrangements and is the exclusive tool available to the government. Though Subpart F would apply to captive insurance, if it were insurance, the legislative history of the statute indicates that Congress was concerned with a quite different problem: the avoidance of U.S. tax by insurance companies who, through the use of foreign insurance companies, were either reinsuring the business of their American affiliated insurance companies or were directly insuring United States risks. There is no indication in the legislative history that Congress was aware of operating companies attempting to deduct premiums paid to their own insurance companies.

Indeed, Congress has recently indicated twice that Subpart F was not meant to deal directly with self-insurance of related parties' United States risks by wholly-owned foreign insurance affiliates. In explaining its proposed amendments to Subpart F later enacted as part of the Tax Reform Act of 1984, the Senate Finance Committee stated:

In adopting this change, the committee recognizes that it is not directly addressing all the problems associated with the use of controlled foreign corporations as captive insurance companies in sophisticated self-insurance arrangements for related persons. The committee does not intend that the provision be construed as affecting any determination as to whether a payment made to a related insurer constitutes self-insurance, the "premium" for which is nondeductible.

The Conference Report to the Tax Reform Act of 1986 also discusses the effect of some of the reported captive insurance cases.

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215 Carnation, 71 T.C. at 412.
217 This is also the view of other authors. See O'Brien & Tung, supra note 18, at 720.
218 Tax Reform Act of 1984, Pub. L. No. 98-369, § 137(a), 98 Stat. 494, 672 (codified at I.R.C. § 954(e)).
Subpart F, as one would expect, does not have the impact on captive insurance that an absolute denial of a deduction has. The denial of a deduction has a substantial impact on a U.S. taxpayer even where the insurer is a U.S. corporation. Subpart F does not deal with the deferral aspects of insurance versus self-insurance, but with the deferral aspects of having a foreign insurance company as opposed to a domestic insurance company. The history of Subpart F has shown a progressive effort by Congress to curtail deferral. The Tax Reform Act of 1986 has made dramatic changes to eliminate the deferral benefits of using a foreign insurer.

Prior to the Tax Reform Act of 1986, the underwriting income of a controlled foreign corporation from the insurance of U.S. risks was currently taxed to its shareholders. Pursuant to the Tax Reform Act of 1984, Subpart F also included as foreign base company income the underwriting income with respect to primary insurance with a related party if the losses occur outside the country of incorporation of the insurance company. The earlier Senate Finance Committee Print indicated that “[t]his provision will apply only if a valid insurance arrangement is found to exist.” Under the Tax Reform Act of 1986, however, insurance income for purposes of section 953 is now defined as any income from insurance derived from risks arising outside the insurance company’s place of incorporation or organization. The Act thus expands Subpart F’s coverage to unrelated parties’ non-U.S. risks.

The investment income of the foreign captive is potentially foreign base company income, taxable to a U.S. shareholder under Subpart F. Prior to the Tax Reform Act of 1986, there were, however, two principal exclusions for insurance companies. The first was that investment income received from an unrelated party that represents the investment of unearned premiums or reserves

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219 For cases dealing with U.S. captives, see Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985); Beech Aircraft Corp. v. United States, 1984-2 U.S. Tax Cas. (CCH) ¶ 9803 (D. Kan. 1984), aff’d, 797 F.2d 920 (10th Cir. 1986); Crawford Fitting Co. v. United States, 606 F. Supp. 136 (N.D. Ohio 1985).
221 Tax Reform Act of 1984, Pub. L. No. 98-369, § 137(a), 98 Stat. 494, 672 (codified at I.R.C. § 954(e)).
222 S. Print No. 169, supra note 219, at 384.
224 See I.R.C. §§ 951, 952, 954.
Captive Insurance was not foreign base company income. Additionally, income derived from the investment of amounts representing one-third of earned premiums (paid by unrelated parties only) was also excluded from foreign base company income. Under the Tax Reform Act of 1986, however, these exclusions were repealed. Any foreign base company income derived by the controlled foreign corporation from foreign sources is foreign source income for purposes of the foreign tax credit.

These rules of Subpart F were modified even further under the Tax Reform Act of 1986 for certain captive insurance companies. For the purpose of taking into account related party insurance income, a U.S. shareholder is any U.S. citizen who owns any stock in the insurance company, and a controlled foreign corporation is one in which U.S. shareholders own twenty-five percent or more of the company.

There are three general exceptions to the captive insurance company rules. First, the provision does not apply where less than twenty percent of the voting stock and value of the insurance company is owned by insureds or persons related to the insureds. Secondly, the provision does not apply where less than twenty percent of the company’s insurance income is derived from related parties. Finally, where the insurance company elects to treat its related party insurance income as effectively connected with a U.S. trade or business, the captive insurance company rules do not apply.

The income of a controlled foreign corporation insurance com-

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228 See I.R.C. § 954(c)(3)(C).
230 Subpart F income under § 951(a) is included as U.S. source income for foreign tax credit purposes to the extent that the income is attributable to income derived by the U.S.-owned foreign corporation from sources within the United States. See I.R.C. § 904(g)(1)(A)(i), (2). The legislative history of the Tax Reform Act of 1984 indicates that Subpart F income derived from the insurance of U.S. risks previously would have been foreign source, thus permitting the U.S. owners potentially to “pay no U.S. tax and no foreign tax on this artificially converted foreign source income” prior to the 1984 Act. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 918, reprinted in 1984 U.S. Code Cong. & Admin. News 1445, 1606.
pany is determined on the basis of insurance accounting principles. Thus, if captive insurance is respected for tax purposes, Subpart F does not affect the tax advantages of captive insurance versus self-insurance. However, the dramatic changes in Subpart F made by the Tax Reform Act of 1986 minimize any tax advantage for foreign captive insurance as compared with domestic captive insurance.

If captive insurance is not recognized as insurance, the application of Subpart F is limited to investment income of the captive. This could have a substantial impact on taxation. Were the only business of the captive the insurance of related parties, then the captive would not be an insurance company taxable as such, because none of its business would be insurance. Thus, its investment income would be foreign base company income not subject to any pre-Tax Reform Act of 1986 exclusions for insurance companies. Should the captive have unrelated business, it may still be considered an insurance company and subject to Subpart F with respect to that business.

B. Section 482 of the Code

Section 482 presents one of the government's principal tools for examining the fairness of transactions between related parties. This tool has not been used by the government in any of the captive insurance cases so far because the government has made a frontal attack on these arrangements by contending that they are not insurance. Certainly, an examination of the transactions on the basis of an arm's-length standard would depend on whether the transactions were first accepted as insurance.

Were captive insurance considered insurance, however, section 482 would have to be considered. Section 482 gives the Secretary of the Treasury broad powers to allocate income and deductions between related parties "in order to prevent evasion of taxes or clearly to reflect the income" of such taxpayers. As provided in the regulations:

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233 See supra notes 19-37 and accompanying text.
235 See I.R.C. § 482.
236 See supra note 140 and accompanying text.
237 I.R.C. § 482.
The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.\footnote{\textit{Treas. Reg.} § 1.482-1(b)(1).}

The focus of section 482 with regard to captive insurance should be on the fair pricing of the insurance product in a situation where overpricing may be considered to provide a tax advantage. Viewing captive insurance transactions through the looking glass of section 482, they may present some factors that deserve special consideration. As mentioned earlier, captive insurance may provide several non-tax advantages vis-a-vis traditional insurance: broader coverage than obtained in the market and insurance of otherwise uninsurable risks.\footnote{See Greene, supra note 16, at 254.} But the third and most important non-tax advantage perceived for captive insurance is cost savings over traditional insurance.\footnote{Id.} These factors require that pricing considerations be focused upon to ensure that the taxpayer is not attempting to evade taxes in contravention to section 482.

It is often perceived by some operating companies with a favorable insurance record that commercial insurance carriers do not give sufficient consideration to favorable loss experience in setting an insurance rate.\footnote{Id.} Certainly a captive could take such experience into account. Assuming as a starting point, however, that the management of the affiliated group sets an insurance rate based on a perception of what the commercial insurance market would charge for coverage,\footnote{Id.} should a more favorable claims ratio be a factor in reducing the rate charged in a captive insurance transaction?

For example, in \textit{Mobil}, the government submitted an analysis of loss experience of the Mobil captive insurance companies versus
that of U.S.-based stock reinsurance companies. The study showed the loss experience of the former to be much lower than that of the latter.\textsuperscript{243} Such results could be the consequence of many factors, including overpricing, good luck, reduced claims adjustment expense, better loss control by the insured, or an attempt to accumulate reserves for catastrophic losses. Price adjustments based on favorable loss ratios may be quite difficult in practice to determine.

General expenses of a captive insurer may also be considerably lower than expenses for a commercial insurer. This can be due to the fact that little or no expense need be incurred for acquisition of the insurance business (commissions and brokers' fees) and general administration and claims investigation expenses can be minimal in a controlled situation. For example, Mobil prepared a study which compared the general expenses of one of its captive insurance companies with general expenses incurred by U.S. stock insurance companies. The general expenses of the former were dramatically lower than those of the latter.\textsuperscript{244}

Expense savings resulting from lower loss costs and lower general expenses can result in higher underwriting profits. In \textit{Mobil}, the government elaborated on the results of the two studies mentioned above to make the point that the Mobil captive insurers were much more profitable than a typical U.S. stock insurance company.\textsuperscript{245} These factors suggest that the Service arguably should look very carefully at pricing considerations when examining a captive insurance relationship under section 482. Pricing that is "in line" with typical insurance policies may still deserved special attention, due to the expense and profit experience discovered in \textit{Mobil}. The Secretary might propose downward adjustments to the premium rates under section 482 based on the view that these types of savings represent special circumstances which would be taken into consideration in an arm's-length price. Indeed, one commentator has reported that the Service has used section 482 in this manner.\textsuperscript{246} It should be noted, however, that section 482 was not raised

\textsuperscript{243} For an exhibit prepared by the government's expert, Dr. Irving Plotkin, illustrating this analysis, see infra at p. 325 (Table I).

\textsuperscript{244} For Mobil's exhibit illustrating this relation, see infra at p. 326 (Table II).

\textsuperscript{245} For the government's illustration of this point, using an exhibit prepared by Dr. Plotkin, see infra at p. 327 (Table III).

in Mobil. The court, however, did comment on these factors:

The expenses for GOIC and Bluefield, wholly-owned insurance affiliates, were considerably lower than expenses of an unrelated insurance company. GOIC and Bluefield did not generally pay commissions in respect to their direct insurance. Administrative expenses were also less. In terms of commercial insurance expectations, GOIC’s and Bluefield’s profits were extraordinarily high.\textsuperscript{247}

The court did not go on to make any finding to the effect that the premiums charged were fair and reasonable.\textsuperscript{248}

Thus, should taxpayers prevail on the captive insurance issue, the Service should subject their captive insurance operations to careful scrutiny and challenge under section 482.

\textbf{VII. Conclusion}

Federal courts have had many recent opportunities to consider the captive insurance phenomenon. From these decisions, a trend has been clearly established: an economic family of corporations does not obtain true insurance coverage from its own insurance affiliate. This result, however, was not foreordained because of the reliance on traditional substance-over-form and sham transaction tax doctrines and the uncertainty that is fundamental in their application. But the trend established in recent captive insurance cases was predictable due to the large potential for tax avoidance with captive insurance transactions and because such insurance is essentially a risk-retention device. The trend advanced by the courts’ opinions, and the opinions themselves, serve as a general guideline to taxpayers that captive insurance is subject to the test of economic reality.

In spite of the recent court attention to the captive insurance issue, several questions regarding partial ownership of a captive insurer and the effect of third-party insureds on the question of whether insurance is present remain unsettled. As demonstrated in this article, however, economic and insurance theory indicate that the presence of unrelated party business has no effect on whether insurance exists between the parent organization and its captive. Thus, tax planners should be aware that unrelated party business

\textsuperscript{247} 8 Cl. Ct. at 559.

\textsuperscript{248} Id. at 568.
is not the panacea it was once perceived to be. The application of economic theory also indicates that to the extent the insured owns the insurer, risk has not been transferred. Therefore, this article argues that when an insurance company is partially owned by an insured, the insured's premium is not for insurance to the extent of the percentage of the insured's premium that reflects the insured's ownership of the insurer.

However, arguments based on pure economic theory with regard to partial ownership have been limited by the Service. Where control and significant ownership are lacking, the taxpayer has in fact transferred a large portion of the risk covered by the contract and the transaction bears only partial resemblance to classic self-insurance. Control is inherently a factual problem which cannot be determined by absolute percentages of ownership. Despite the holding in *Crawford Fitting*, it appears the issue is not resolved.
Table I

Comparison of Loss Ratios

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<th>Stock Reinsurance Companies U.S. Owned [Mobil Captives]</th>
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<td>55.5</td>
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<td>27.5</td>
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<td>60.2</td>
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<td>1965</td>
<td>41.0</td>
<td>63.5</td>
<td>22.5</td>
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<td>61.1</td>
<td>13.0</td>
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<tr>
<td>1969</td>
<td>80.5</td>
<td>63.2</td>
<td>(17.3)</td>
</tr>
</tbody>
</table>

 Defendant's Exhibit No. 354, at Table 28, Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985) (No. 358-78) (copy on file). The data contained in this exhibit for industry comparisons was obtained from Best’s Aggregates and Averages: Property-Casualty.
Table II

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<td>44.2</td>
</tr>
<tr>
<td>Permissible Loss Ratio</td>
<td>47.0</td>
<td>47.0</td>
<td>50.8</td>
<td>50.8</td>
</tr>
<tr>
<td>Expected Profit</td>
<td>51.1</td>
<td>5.0</td>
<td>47.3</td>
<td>5.0</td>
</tr>
<tr>
<td></td>
<td><strong>100.0 %</strong></td>
<td><strong>100.0 %</strong></td>
<td><strong>100.0 %</strong></td>
<td><strong>100.0 %</strong></td>
</tr>
</tbody>
</table>

Plaintiff's Exhibit No. 483, Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985) (No. 358-78) (copy on file).
Table III

Adjusted Underwriting Profit Margin
(100 — Combined Ratio)

<table>
<thead>
<tr>
<th>Year</th>
<th>GOIC/Bluefield</th>
<th>Stock Reinsurance Companies</th>
<th>Times More Profitable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>64.7</td>
<td>0.5</td>
<td>129.4</td>
</tr>
<tr>
<td>1961</td>
<td>43.3</td>
<td>2.9</td>
<td>14.9</td>
</tr>
<tr>
<td>1962</td>
<td>74.0</td>
<td>3.4</td>
<td>21.8</td>
</tr>
<tr>
<td>1963</td>
<td>70.4</td>
<td>0.6</td>
<td>117.3</td>
</tr>
<tr>
<td>1964</td>
<td>53.2</td>
<td>0</td>
<td>∞</td>
</tr>
<tr>
<td>1965</td>
<td>54.0</td>
<td>(2.7)</td>
<td>not meaningful</td>
</tr>
<tr>
<td>1966</td>
<td>43.2</td>
<td>0</td>
<td>∞</td>
</tr>
<tr>
<td>1967</td>
<td>42.5</td>
<td>0.5</td>
<td>85.0</td>
</tr>
<tr>
<td>1968</td>
<td>46.8</td>
<td>1.8</td>
<td>26.0</td>
</tr>
<tr>
<td>1969</td>
<td>13.8</td>
<td>2.7</td>
<td>5.1</td>
</tr>
</tbody>
</table>

Defendant's Exhibit No. 354, at Table 31, Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985) (No. 358-78) (copy on file).