Captive Taxation Case Law Summary
By Tom Cifelli, June 2011

Background

The United States Supreme Court in Helvering v. LeGierse, decided in 1941, established the framework for what is insurance, and therefore deductible when paying a premium while allowing accelerated deductions for future loss reserves, as opposed to being merely a form of self-insurance which does not have any special tax benefits. The Helvering case established rules requiring risk "shifting" and risk "distribution." The court ruled that if the risk of loss is not shifted from one party to another, then it is not insurance qualifying for special tax treatment.

Many court cases have added depth and complexity to the analysis. Most of these disputes arose due to the IRS enacting restrictive revenue rulings such as 77-316 attempting to limit the application of the principles emerging from Helvering and related cases. Some major decisions between taxpayers and the IRS on this long road to some stability and consensus on taxation of captive insurance companies include Humana (1989), Gulf Oil (1990), Americo (1991), Harper (1992) and Hospital Corp of America (2004). The battle in these cases was whether a captive insurance company was designed to sufficiently meet the risk shifting and risk distribution requirement to receive beneficial tax treatment. The IRS lost on most issues throughout this series of cases.

Key Cases Summary:

Caveat: Please note that subsequent IRS rulings and case law impact the findings of some of these older cases. These are however generally considered the line of cases setting forth the framework for forming and operating insurance companies.

Helvering v. LeGierse, 312 U.S. 531 (1941). Established that both risk shifting and risk distribution are requirements for a contract to be treated as insurance.

Carnation Co. v. Com'r., 71 T.C. 400 (1978), aff'd, 640 F.2d 1010 (9th Cir. 1981), cert. denied, 454 U.S. 965 (1981). Denied a deduction for premiums paid by a parent corporation to an unrelated U.S. insurer to the extent the premiums were ceded (pursuant to a reinsurance arrangement) by the insurer to the parent's wholly owned Bermuda captive. The court's decision hinged on its determination that the captive wrote no unrelated risk, was inadequately capitalized and entered into an agreement under which the parent could be compelled to contribute additional capital to the captive.

Stearns-Roger Corp. v. Com'r, 577 F. Supp. 833 (D. Cob. 1984), aff'd, 774 F.2d 414 (10th Cir. 1985). The U.S. District Court held that premium payments by a parent to its wholly-owned captive subsidiary were not deductible based on the "economic family" doctrine. The 10th Circuit Court of Appeals supported the denial, but rejected the economic family argument.

Clougherty Packing Co. v. Com'r., 84 T.C. 948 (1985), aff'd, 811 F.2d 1297 (9th Cir. 1987). This complex Tax Court decision, disallowing captive premium deductions, touched on many controversial issues and resulted in wide differences of opinions among the 19 judges.

Crawford Fitting Co. v. U.S., 606 F. Supp. 136 (N.D. Ohio 1985). The court held that insurance premiums paid to a Captive by a group of separate corporations that were owned and controlled by a group of

related individuals were deductible because the shareholder/policyholders of the captive were not so economically related that their separate financial transactions had to be aggregated and treated as the transactions of a single taxpayer.

Humana, Inc. v. Com'r, 881 F.2d 247 (6th Cir. 1989). The 6th Circuit Court of Appeals held that the brother-sister captive arrangement constituted insurance for federal income tax purposes and, as such, premium payments attributable to the risk exposures of the captive's brother-sister entities (but not the parent) were deductible. The Court's decision was based on the so-called "balance sheet" approach, under which risk shifting depends on the effect of the arrangement on the policyholder's net assets. This case clearly starts laying the foundation for the economic substance doctrine analysis to determine of the legal and financial relationships between the party change sufficiently independent of the tax effects to consider the arrangement as insurance.

Kidde Industries, Inc. v. U.S., 40 Fed. Cl. 42 (Cl. Ct. 1997). Applying the balance sheet approach articulated in Humana, the Court held that premium payments made by brother-sister entities to the captive were currently deductible. In contrast, payments made by divisions of the parent corporation did not constitute insurance premiums deductible under IRC §162.

The Harper Group v. Com'r, 96 T.C. 45 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992). The Tax Court held, and the 9th Circuit Court of Appeals affirmed, that risk shifting and risk distribution were present where the captive received 29 to 32 percent of its premiums from unrelated parties. As such, the captive arrangement was found to constitute insurance for federal income tax purposes and payments made to the captive were deductible under IRC §162. Today this "30% unrelated risk" threshold is heavily relied upon by more and more captive designs to protect the captive from adverse tax audit findings. Due to most employee benefits being considered 3rd party risks, small company captives will increasingly be designed to issue medical stop loss in combination with enterprise risk coverages to meet risk shifting and distribution requirements. Eventually the IRS will likely issue another safe harbor ruling on to supplement Rev. Rul. 2002-89, 90 and 91. It would also be helpful if the IRS establishes some safe harbor guidelines on ration of 831(b) captive premium levels as a percentage of insured companies gross revenues (this should apply to enterprise risk lines only not employee benefit or traditional P& C coverages) similar to how retirement plans have contribution limits based on gross income.

Inverworid v. Com'r, T.C. Memo 1996-301, supplemented by, T.C. Memo 1997-226. Transacting offshore company's business through a U.S. office found to constitute engaging in a U.S. business for federal income tax purposes.

United Parcel Service vs. Com'r, T.C. Memo 1999-268 (1999), rev'd, 254 F.3d 1014 (11th Cir. 2001). The 11th Circuit found that the Tax Court had improperly determined that a restructured program in which a shipping corporation transferred its "excess value charge" income and obligations to a Bermuda insurance company was a tax sham. The Tax Court opinion describes the economic-substance doctrine as follows, "This economic-substance doctrine, also called the sham-transaction doctrine, provides that a transaction ceases to merit tax respect when it has no 'economic effects other than the creation of tax benefits.' [Citations omitted]. Even if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance."

END OF MAJOR CASE SUMMARY