Tax Court May Have Eased Rules on Captive Insurance Deduction

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The Tax Court has continued the trend to greater acceptance of the captive insurance deduction by allowing a parent's guarantee of a captive insurance subsidiary's liabilities when the guarantee is made for regulatory purposes.

The Code allows taxpayers to deduct business expenses, including insurance expense. One technique used by taxpayers in an attempt to deduct these insurance expenses is to incorporate their own insurance companies, called captive insurance companies. After decades of litigation, it became clear that parent corporations could not deduct payments made to their captive subsidiaries, because there was no shifting of risk. [1] However, if the subsidiary was not 100% captive but did enough insurance business with unrelated parties, there was a shifting of risk and the premiums paid by the parent would be deductible. [2]

While a simple subsidiary generally did not work, if the parent put its operations into subsidiaries, created a captive insurance subsidiary, and had the operating subsidiaries buy insurance from the captive insurance subsidiary, a shifting of risk along with a deduction for the subsidiaries was created, [3] as long as the captive was adequately capitalized and the parent did not reassume the risk by guaranteeing its debts/liabilities. [4] In a recent case, the Tax Court approved what appears to be a debt liability guarantee by the parent company. [5]

BACKGROUND

Section 162 allows as a deduction all ordinary and necessary trade or business expenses. Insurance was not and is not defined in the Code or regulations, [6] but the Supreme Court construed it in an early case. [7] There, an 80-year-old woman simultaneously purchased a life insurance policy and an annuity

policy from the same insurance company. The insurance policy would not have been issued unless the annuity policy had been purchased, but in all other respects the transactions were treated separately. The woman was not required to pass a physical or answer questions an applicant normally would have to answer. The woman died, her estate received the insurance proceeds that were excluded from her gross estate, and the issue was whether this was insurance.

The Court found that to have insurance, there must be insurance risk consisting of two factors: risk shifting and risk distribution. Risk shifting occurs when the insured buys coverage from the insurer: the risk of loss is shifted from the insured to the insurer. Risk distribution occurs when the insurer sells policies to multiple parties in order to spread the risk of loss among many customers. In this case, the Court found no risk shifting. From the insurer's view, they had covered both sides of the insured's risk of dying. If she lived, it paid the annuity but made money on the single-payment insurance premium. If she died, it made money on the annuity and the insurance proceeds had already been covered by the single-payment premium. Taken together, the annuity contract and the insurance contract "neutralize(d)" each other. Thus, this was not insurance, so no exclusion.

Taxpayers who simply set aside money in an account for self-insurance, of course, cannot deduct anything; they still have the risk; it has not been shifted. [8] Attempting to avoid this problem, corporate taxpayers created a subsidiary insurance company that sold policies back to the parent; this did not work any better. There are several cases on the parent-subsidiary organization. In the first one, [9] the parent incorporated a subsidiary captive insurance company; it was duly licensed as an insurance company. The parent then purchased insurance from an unrelated insurance company, which reinsured 90% of the coverage with the captive insurance subsidiary. The parent had initially capitalized the captive with $120,000, the minimum amount required by Bermuda law. The unrelated insurance company believed the captive was undercapitalized and would not proceed, so the parent executed an agreement to invest another $2,880,000 in the captive if the captive so requested or if the parent decided to do so. This satisfied the unrelated company. The parent then paid $1,950,000 of premiums to the unrelated insurance company, of which 90% or $1,755,000 was paid to the captive. All of the subsidiary's business was with the parent. The Service disallowed the parent's deduction of the insurance premiums paid to the captive.

Applying *LeGierse*, the Tax Court held that insurance required both risk-shifting and risk-distributing. Noting that *LeGierse* had considered the two separate agreements together to determine that there was no shifting of risk, the court considered the insurance policy with the outside insurer, the agreement to capitalize the captive up to $3 million, and the agreement by the captive to reinsure the parent's risks

together, and found that the three agreements resulted in no shifting of risk; they "neutralize(d)" each other. To the extent that the parent was willing to capitalize its captive, there was no transfer of risk to the captive.

The court did not analyze the issue of corporate entities needing to be treated separately holding that, in *LeGierse*, the Supreme Court never addressed the separate nature of the parties; the corporations did not file consolidated returns. Treating separate corporations separately is a major theme running through these cases, stemming from a Supreme Court decision holding that as long as a corporation has a useful business purpose and that "purpose is the equivalent of business activity or is followed by the carrying on of business(,) ... the corporation remains a separate taxable entity" as long as there is no tax fraud or sham. [10] In *LeGierse*, the parties were the insurance company and the insured individual, so there was no real reason to note separateness. The Court ignored the unrelated insurance company that received the premiums first; it is treated as a conduit, but never called such.

The Court also never found that the captive was "undercapitalized" although the unrelated insurance company thought so. The fact that the outside insurance company needed more protection seems to indicate the captive was undercapitalized and, when citing *Carnation*, other courts have called the captive undercapitalized. The entire decision was based on the three agreements, taken together, as not shifting the risk from the parent to the captive, which is a straightforward application of *LeGierse.*

Finally, the Service argued the "economic family" theory, but the Court found no insurance so it did not address it. This theory states that, because a subsidiary is owned by the parent, there can never be a real shifting of risk because any losses to the subsidiary are ultimately born by the parent. [11]

The Ninth Circuit affirmed *Carnation* in 1978, holding that the Tax Court decision was not clearly erroneous. It also noted that situation 2 in **Rev. Rul. 77-316** , [12] the revenue ruling which provided the economic family theory, was identical to the facts in *Carnation.* Although the revenue ruling held that such payments were not insurance and could not be deducted, the appellate court based its decision on *LeGierse.*

In the second case, a captive insurance company was incorporated as effectively a 100% subsidiary. [13] The captive was originally capitalized with $1 million, but the parent issued an agreement to add capital up to $3 million. This guarantee was never used, so it was ignored by the court. The parent paid insurance premiums to the captive which, in turn, provided insurance policies to the parent. The premiums were deducted by the parent and disallowed by the Service.

The court relied on *LeGierse*, *Carnation,* and **Rev. Rul. 77-316** . It found that the parent and captive were separate entities and that the captive was formed for a legitimate business purpose, but the court seemed to adopt the "economic family" argument of *Carnation* and **Rev. Rul. 77-316** and found no shift of risk. However, there was enough discussion of substance over form, so that the court need not have adopted that ruling. The Tenth Circuit affirmed this case in 1985, deciding that this looked more like self-insurance than insurance, which had been found nondeductible in *Spring Canyon Coal Co.* [14] The appellate court also discussed the *Moline Properties* rule, finding that this holding did not disregard the separate entities of parent and subsidiary. [15]

Later, in 1984, the district court of Kansas held that insurance premiums paid to a captive subsidiary were not deductible as there was no shift of risk. [16] In this case, the captive, organized in Bermuda, was capitalized with $150,000 to handle up to $2 million of losses. The parent made no guarantees for further capitalization. The court cited *LeGierse* and *Carnation,* but not **Rev. Rul. 77-316** . The decision was based on substance over form, with the court finding that any subsidiary loss would be reflected on the parent's financial statement almost exactly as if the parent had suffered that loss itself. The undercapitalization was a factor, in finding that the parent would have to bear the subsidiary's loss, but not conclusive because any loss by the subsidiary would reduce the net worth of the parent. The Tenth Circuit affirmed this reasoning in 1986, without adding anything new. [17]

In 1985, an Ohio district court held that these insurance premiums were deductible. [18] The insurance company was not a subsidiary of the taxpayer corporation nor was it owned by *exactly* the same people, even though there was 80% common ownership.

The taxpayer was one of four subsidiaries owned by Crawford Companies which was 100% owned by a husband, wife, and daughter. The subsidiaries manufactured items and sold them to four individually incorporated warehouses that were owned 100% by the same husband, wife, and daughter, but in different percentages. The warehouses resold the goods to independent Crawford distributors. One warehouse incorporated an insurance company, owning 80% of it. The other 20% was owned by a combination of the taxpayer's assistant secretary, its in-house counsel, and its outside counsel. The taxpayer did not directly own any of the insurance company. The insurance company was originally capitalized for $1 million, and there was no agreement by the Crawford Companies to indemnify it. The insurance company was created for a legitimate business purpose.

All of the previous opinions discussed above and **Rev. Rul. 77-316** were cited and distinguished by the court which first noted that there was no direct financial interest between the taxpayer and the insurance

company. The court refused to attribute the 80% common ownership of the taxpayer's shareholders and the insurance company shareholders into an economic unit. It used the 20% owned by non-family members as additional evidence of different ownership. The Court noted that the insurance company covered not only the husband and the taxpayer, but the other manufacturing companies, certain suppliers, 115 independent distributors, the profit-sharing trust, and others, all of which were independent actors. Finally, the court acknowledged that the insurance company was not underfunded. According to the court, there had been a shift of risk from the taxpayer to the shareholders of the insurance company. This case was neither appealed nor acquiesced by the Service. It has not been cited much either, probably because of its peculiar facts.

The facts of *Clougherty* [19] return to a captive subsidiary with predictable results. The parent corporation had a subsidiary that incorporated the captive insurance company as its subsidiary. The parent bought insurance from an unrelated insurance company and then that company reinsured 92% of these risks with the parent's captive insurance subsidiary. The parent paid 100% of the premiums to the unrelated insurance company, which then paid 92% to the captive insurance company as part of the original agreement with the unrelated insurance company. The captive was a licensed insurance company and was adequately capitalized in the appropriate state. There was no agreement by the parent to guarantee losses to the captive or otherwise fund the captive. The IRS disallowed the insurance deduction.

The Tax Court held that while *Carnation* was controlling, the parent's guarantee of funding for the subsidiary was not determinative; the test was whether, considering all facts, the risk had shifted. Here, the court held that there was no risk shifting as the premiums were paid to a 100% subsidiary of the parent's 100% subsidiary. The court really did not explain its rational; it just said that *Carnation* was controlling and held the same way.

Addressing the separate corporate entities issue, the court cited *Carnation* as not ignoring the corporate separateness. This was a reclassification of deductible to nondeductible expenses, similar to unreasonable compensation being reclassified as dividends and loans to capital contributions. Finally, the Court rejected the "economic family" theory.

In affirming the Tax Court, the Ninth Circuit reiterated all of the statements made by the Tax Court. [20] Then, the Court adopted the rule that it needed to look only at the parent's assets. It explained that if the captive paid claims, the value of captive's stock would go down exactly as much as the claims paid, and that loss in stock value would reduce the parent's assets correspondingly. So, even if the subsidiaries are treated as separate corporations, the parent suffers their loss, so the risk of loss has not been shifted.

With this approach, there is no violation of the *Moline Properties* rule. According to the court, the parent corporation lost exactly as much as the captive insurance subsidiary paid out in claims, so there was no shifting of the risk to the captive. The Ninth Circuit's test of looking only at the parent's balance sheet would be adopted by most courts.

Shortly thereafter, the Claims Court decided *Mobile Oil.* [21] In this case, the parent incorporated a subsidiary that incorporated the captive insurance company. [22] At all times, the parent owned the captive only indirectly. The court cited all the cases listed above, but using a substance-over-form analysis, decided that paying insurance premiums to a wholly-owned subsidiary was the same as self-insurance. The risk of loss stayed with the parent and was reflected on the parent's balance sheet, and thus not deductible. This case was not appealed.

To this point, the courts had decided that premiums paid to a subsidiary are generally not deductible because there is no shifting of risk off the parent. The presence of a parental indemnity agreement or an undercapitalized captive provides evidence of no shifting of risk. However, if the subsidiary does enough insurance business outside of the corporate group (as little as 30% of its total business), there is an adequate risk shift. Also, if the captive was not owned by the taxpayer, but mostly by the same owners as the taxpayer's owners, although not in the same percentage ownership, the premiums might be deductible. From this point, it did not take much imagination for taxpayers to switch from a parent-subsidiary relationship to a brother-sister one.

HUMANA

In *HumanaInc.,* 88 TC 197 (1987), *aff'd in part, rev'd in part* **64 AFTR 2d 89-5142** , 881 F2d 247, 89-2 USTC ¶9453 (CA-6, 1989), the parent owned an undisclosed number of operating subsidiaries. For legitimate business purposes, the parent incorporated a captive insurance company (in Colorado), which issued policies to the parent and each of the subsidiaries. The parent paid for the insurance and charged back the appropriate amount to the subsidiaries. The captive was adequately funded, and there was no indemnity agreement from the parent or subsidiaries for the benefit of the captive. The IRS disallowed the parent's deduction of all the premiums.

The Tax Court divided the case and determined whether the premiums paid for the insurance of (1) the parent and/or (2) the subsidiaries were deductible. The court found no shift of risk for the premiums paid for the parent's insurances, using the same rationale used in *Carnation* and *Clougherty.* Then, it applied

the same reasoning to the subsidiaries' insurance payments. The court did not adopt the "economic family" doctrine, but did apply the substance-over-form doctrine for the entire group. It reasoned that no matter how the assets were split among subsidiaries, all the risk was borne by the parent, so there was no risk shifting and thus no insurance.

The Sixth Circuit, in reversing as to the subsidiaries, looked only to the balance sheets of the operating subsidiaries, finding that they had shifted their risk to the captive, which is, of course, true. Once the premium is paid, the subsidiaries have no more risk of loss; it is now with the captive. The appellate court specifically said that *MolineProperties* controlled and unless there was no business purpose in forming the captive or the captive was a fraud or sham, the captive had to be treated as a separate entity. The court followed the Ninth Circuit's lead in *Clougherty*, which looked at the assets of the *insured* parties. In the present case, these were the operating subsidiaries. There was a transfer of risk from the insured subsidiaries to the captive. *Moline Properties*, however, prevented analyzing the effect on the parent.

Absent specific congressional intent, the court also said that the substance-over-form doctrine could be applied only when the subsidiary was a fraud or sham or had no business purpose; it was not a general doctrine to be used anywhere. Additionally, the court mentioned in a footnote that either undercapitalization or a parental guarantee of the captive would be enough to find that there was no risk shifting and the IRS would prevail. The footnote was vague enough, however, that confusion arose as to whether both or just one of these factors needed to be present. In *Malone&HydeInc.*, **76 AFTR 2d 95-5952** , 62 F3d 835, 95-2 USTC ¶50450 (CA-6, 1995), the Sixth Circuit stated in dictum that only one factor was necessary.

GULF OIL

In *GulfOil*, **66 AFTR 2d 90-5552** , 914 F2d 396, 90-2 USTC ¶50496 (CA-3, 1990), the parent and its affiliates had previously purchased insurance from outside insurers. It created a captive insurance subsidiary organized in Bermuda. Although the captive was authorized for $10 million of stock, only $120,000 was originally invested, which was the minimum required by Bermuda. Five years later, the paid-in capital was raised to $10 million. Insurance was purchased from outside insurers but reinsured with the captive. The parent executed guarantees to the outside insurers indemnifying them if the captive defaulted on its reinsurance obligations. The premiums paid to the captive were deducted by the parent; the IRS denied the deductions; the Tax Court agreed with the IRS. [23]

The Third Circuit did not address the brother-sister organization but agreed with the result of *Humana.* It differentiated *Humana* in that: (1) the *Humana* captive started off as a fully capitalized company and the captive in this case did not; (2) *Humana* had never given guarantees to protect the outside insurers, but the parent in this case did; (3) *Humana* never contributed additional capital to its captive nor had it taken any steps to insure the captive's performance, both of which the parent did in this case. Clearly, the parent's guarantee to the outside insurers and the fact that, at least initially, the captive was underfunded persuaded the Third Circuit that there had been no shift of risk to the captive. As an aside, in this case, the captive did 2% of its business outside the group. The parent argued that this showed that the captive was really an insurance company, but the court found 2% to be de minimis.

MALONE & HYDE

In *Malone & Hyde*, the parent had several operating subsidiaries and incorporated a captive insurance company in Bermuda. The parent entered into an insurance contract with an outside insurance company, which then reinsured the first $150,000 of each claim with the captive. The captive's only assets were the $120,000 paid by the parent for all of the captive's capital stock, the minimum capital required in Bermuda. The captive provided an irrevocable letter of credit in the amount of $250,000 (later raised to $600,000) to the outside insurer. The parent also gave a "hold harmless" agreement to the outside insurer, promising not to sue the outside insurer if it ever became liable because the captive defaulted on its reinsurance obligations. The payments to the captive were deducted; the IRS denied the deductions; the Tax Court allowed the deductions, based on *Humana.* [24] This case was appealed to the Sixth Circuit, which had decided *Humana.*

On appeal, the court never addressed the brother-sister situation, but held that the captive was essentially a sham corporation based on three factors. First, unlike the parent in *Humana*, the parent in this case had no trouble finding outside insurance, so there was no reason to create a captive, but "[it] devised the circuitous scheme for realizing tax deductions ...". This factor is probably not controlling because other courts have allowed captives if their cost was cheaper than outside insurers coupled with limited insurance availability. [25] Second, unlike Humana, which capitalized its captive at $1 million, the captive in this case insured $150,000 per claim with a capital contribution of $120,000. The Tax Court had found the captive adequately capitalized because it met the Bermudian minimums. The appeals court did not directly overrule the Tax Court, but wondered if Bermuda exercised similar control over the captive as Colorado did in *Humana.* Additionally, the hold harmless agreement relieved the outside insurer of the

risk and returned it to the parent. In reference to the *Humana* footnote noted above, the court stated that either undercapitalization or a risk-shifting agreement alone would constitute a sham. In this case, it found both. Finally, it favorably cited *Gulf Oil.*

KIDDE INDUSTRIES

In *KiddeIndustries*, **81 AFTR 2d 98-326** , 40 Fed Cl 42, 98-1 USTC ¶50162 (Fed. Cl. Ct., 1997), the parent had several operating subsidiaries and created a captive insurance subsidiary in Bermuda. The parent bought insurance from outside insurers who reinsurerd with the captive. During part of this time, the parent had an indemnification agreement with the outside insurers. The court found that the indemnification agreement by itself was enough to preclude any deduction for insurance premiums during that time. After that agreement was withdrawn, the parent could deduct insurance paid to the captive on behalf of the operating subsidiaries but not for its own coverage. Predictably, the court found no shifting of risk between the parent and its wholly-owned captive. Interestingly, the court noted that if the captive had enough outside business, there would be a risk shifting, which would allow a deduction to the parent.

Finally, the Court noted that the captive was undercapitalized by American standards. The capital requirement in Bermuda is $120,000; in this case, the captive was initially capitalized at $1 million, later raised to $10 million, which gave it a premium-to-capital ratio of 9:1. In the U.S., most insurance regulators require a 3:1 ratio. Apparently, because the court's decision was based on the indemnity issue, it did not develop the undercapitalization issue. However, just like in *Gulf Oil* and *Malone& Hyde*, this shows that undercapitalization can be found even if local capital requirements are met.

HOSPITAL CORPORATIONOF AMERICA

In *HospitalCorporation ofAmerica,* **TC Memo 1997-482** , RIA TC Memo ¶97482, 74 CCH TCM 1020 , the parent had operating subsidiaries and a captive insurance subsidiary domiciled in Colorado. The facts are similar to the cases above, but there was an indemnity agreement. However, that agreement covered only one business line and that was a very small percentage of coverage, so while the Tax Court held that to the extent of the indemnity agreement, there was no tax deduction, it also found that said agreement was not enough to make the entire captive a sham. The captive was incorporated in Tennessee and was not undercapitalized. The case was appealed to the Sixth Circuit on grounds not relevant here.

RENT-A-CENTER

In *Rent-A-Center*, *Inc.*, **142 TC No 1** , Tax Ct Rep (CCH) 59801, Tax Ct Rep Dec (RIA) 142.1, 2014 WL 128000 , (appealable to the Fifth Circuit) the parent created a captive insurance company to write policies for Rent-A-Center's (RAC's) operating subsidiaries. There was a valid business purpose for creating this insurance company. The captive was incorporated as an insurance company in Bermuda, which required a minimum capitalization of $120,000 and required that the captive meet a minimum solvency standard based on the captive's net premiums, general business assets, and liabilities. The original capitalization was $9.9 million. The annual premium, completely paid for by the parent, was actuarially determined by an independent insurance consultant based on the risks of the entire enterprise; the subsidiaries' individual portion was charged to them by the parent based on their payroll and number of vehicles. There was no actuarial analysis of the risks of each individual subsidiary.

The captive had a calendar year, but all policies covered from December 31 to December 30. The premiums were paid in full on December 31 and taxed in the year received, but, for book purposes, the revenue was prorated, so most of it was earned in the subsequent year, creating a deferred tax asset (DTA). To meet Bermuda's statutory solvency requirements, the captive used these DTAs as general business assets. Of course, the DTAs had no monetary value, so the parent offered to guarantee the full value of the DTAs for the first year, and then after the first year, to guarantee the captive's liabilities up to $25 million for the next three years. Bermuda approved this arrangement. While this guarantee was in effect, the parent never had to pay any amount under it. It was cancelled after three years because the captive could meet the statutory tests without it. The captive never issued insurance to an outside party.

The captive purchased treasury stock of the parent. This was approved by the Bermudian authorities who also agreed to allow the treasury stock to be counted as general business assets. The parent agreed to repurchase those shares at issue price.

The real issue in this case is whether the parent assumed the risk of insurance by guarantying the liabilities of the captive. If so, there was no risk shifting and thus no insurance. The Tax Court majority decided the answer was no. These judges found that the most important factor was that the parental guaranty did not affect the balance sheet or net worth of the subsidiaries insured by the captive. This was the test adopted by the Sixth Circuit in *Humana*. The dissent rightfully pointed out that a parental guarantee will never show up on the books of an insured subsidiary. In *Malone,* the court specifically found that a guarantee would render the captive a sham, and several appeals courts have found that a

parental guarantee meant that the risk had not shifted so there is no insurance. [26] Clearly, if the parent indemnified 100% of the captive's losses, the purported risk shifting would have been between the operating subsidiaries and the parent, not the captive, so the payments from the operating subsidiaries to the parent would not be deductible, even though the parent's balance sheet was not affected.

Second, the majority distinguished the cases of parental guarantee by finding that all such cases also had an undercapitalized captive. In the present case, the court found the captive, which was originally capitalized with $9.9 million, not to be undercapitalized. However, the captive obviously could not meet the Bermudian solvency tests without the parental guarantees reaching $25 million. This is almost an admission by the court that the captive was undercapitalized. The court did not explain how it concluded the captive was solvent. The court stated that the IRS expert testified that the captive was solvent, but that issue was not litigated by the IRS and the court did not explain how the expert reached that conclusion. It ignored the testimony that the captive's premiums-to-surplus ratio was higher than usually occurs in the U.S. because non-captive companies reduce premiums to meet competition, and rely on investing income, so the surpluses seem higher in comparison. Captives do not have that problem so they charge the full amount of premiums, which makes the ratio higher, and they do not rely on investing income as much.

In *Kidde*, the captive was eventually capitalized at $10 million which gave it a premiums-to-surplus ratio of 9:1; the court said 3:1 was generally required by insurance regulators. In this case, the captive was originally capitalized for $9.9 million, which resulted in a premium-to-surplus ratio of between 8.983 and 6.369 to 1 while the guarantee was in effect. In *Kidde*, the court focused on the parental indemnity agreement, and only mentioned, but did not develop, the undercapitalization agreement. Here, the concurring opinion mentioned that the $25 million guarantee was just 10% of the total premiums paid to the captive, but did not mention that it was over 250% of the total capitalization of $9.9 million. Also, in *Gulf Oil*, *Malone,* and *Kidde*, the courts indicated that a captive could be undercapitalized even if local standards were met.

Third, the court held that the purpose of the guarantees was to maintain solvency and liquidity requirements imposed by the regulators and that the parent never paid anything on that agreement. If the court's point was that the parent never paid anything, the question is relevancy. In all of the cases in which an indemnity was held fatal, the parent never had to pay on its guarantee. In *Stearns-Rodgers*, however, the court ignored the parental agreement since the parent never had to pay on it. [27] If the court's point was that the guarantee was just to meet the regulation requirements, this again is almost an admission that the captive was underfunded.

Finally, the court stressed in another part of the opinion that the indemnity in this case was required by the government to cover certain solvency and liquidity requirements, and not by the outside insurers to cover insurance losses as in all prior cases. This is the most important holding of the case. The guarantees were not for insurance losses, but for regulatory purposes, so the parent never reassumed the risk of insurance loss, which meant there was insurance.

The court never made clear its point on this issue; maybe, it is that free market forces are better able to determine undercapitalization than governmental organizations. The dissent did not think much of this distinction. However, in *Sterns-Rodgers*, the court ignored the parental agreement since the parent never had to pay on it.

Five dissenting judges disagreed with the majority opinion, citing the facts that: (1) a guarantee from RAC made it possible for the captive to meet Bermuda's minimum solvency requirements (addressed by the majority); (2) the captive used the premiums it received to invest in RAC's treasury stock instead of third-party investments (not addressed by the majority); and (3) the captive's premiums-to-surplus ratio was higher than the typical ratio of other commercial insurers (this was addressed by the majority). Some of the dissenters were upset that even though the majority had not specifically stated so, *Humana* had been overruled without proper procedure.

There is one final point: the concurring opinion noted that the *Humana* footnote, which said that undercapitalization and parental guarantees are enough to treat the captive as a sham, requires both factors to be present. Later, that concurring opinion, after noting that in this case, the court found no inadequate capitalization, stated that a mere existence of a parental guarantee is not enough to disregard the captive insurer; it was necessary to look to the substance of that guarantee.

At first glance, it may seem that the judge here missed some things, but that is not so. Later in the concurring opinion, the judge cites *Malone & Hyde* in which the Sixth Circuit clarified the *Humana* footnote so that either a parental guarantee or an undercapitalized captive would be a sham. However, in that case, both of these factors were present, so this judge could have interpreted this clarification as dictum and ignored it.

Similarly, the *Humana* footnote cited *Stearns-Roger*, in which the captive was not undercapitalized but in which there was a parental agreement. However, the parent never paid under the agreement so the court ignored it. The holding of nondeductibility of insurance premiums was based on the premiums being paid to a 100% subsidiary, not a brother-sister, so again the judge could have found *Stearns-Roger* not to be on point.

Lastly, the concurring opinion stated that the court must look to the substance of that guarantee. The majority did look to the substance and decided that the guarantee did not vitiate risk shifting for the three reasons discussed above. The concurring opinion follows the majority opinion, stressing that, in prior cases, there was either a blanket indemnity or a capitalization agreement to provide cash greater than the premiums paid to the captive; either of these would cover the insurance losses the captive had.

One final point: the concurring opinion stated that the footnote in *Humana* which says that undercapitalization and parental guarantees are enough to treat the captive as a sham requires both factors. However, the Sixth Circuit, which decided *Humana*, had clarified earlier in *Malone* that either was enough to find the captive was a sham.

In short, the court held, ten votes to six, that the guarantee in this situation was not fatal to the captive insurance company. It is hard to tell if this is an evolutionary or monumental shift. Clearly, the *Rent-A-Center* facts are unique among the cases in this area. Maybe, *Rent-A-Center* should be read narrowly and limited to these facts. In *Hospital Corporation of America*, the court felt that the guarantee covered such a small portion of the business that it should not destroy the entire captive system. Possibly, going from a guarantee for a limited part of the business to a guarantee for a limited purpose, to meet governmental regulations and not pay insurance losses, is the next logical step. However, in *Rent-A-Center*, the guarantee went to whether the captive was viable as an insurance company and ultimately to its solvency, so maybe this is a major shift in the thinking of the Tax Court. It will be interesting to see if this case is appealed.

CONCLUSION

This article has traced the development of insurance as a concept requiring the shifting of risk to another, the sharing of risks among many policy holders, and the arrangement being insurance in the commonly accepted sense. Several cases have held that if the captive was undercapitalized or indemnified by the parent, there was no shifting of risk. Contributions to self-insurance reserves are not deductible and, generally, amounts paid to subsidiary captive insurance companies are not deductible, the exception being when the captive does significant insurance business with unrelated parties. The evolution from parent-subsidiary captives to brother-sister captives has been approved by the courts, again, as long as the captive is fully capitalized and there are no parental guarantees to make up the captive's insurance losses. Finally, parental guarantees in certain circumstances may be permissible. Leniency here makes the most sense when the guarantee is for just a small portion of the insurance business and when

leniency was granted in cases in which the guarantee was just for regulatory purposes, not for insurance losses, and was never used to actually pay third party claims. This last situation is ripe for appeal, and, if upheld, creates a split between the Fifth and Sixth Circuits that could lead to the Supreme Court, although the cases can be distinguished narrowly on the facts, if the Court wishes to avoid the issue.

Exhibit 1. Current Status of Premiums Paid to Captive Insurance Companies

Current Status of Premiums Paid to Captive Insurance Companies	
Captive sub no parental guarantee,* no outside business	Premium not deductible
Captive sub with parental guarantee	Premium not deductible
Captive sub with significant outside business (30% is lowest % courts have allowed), no parental guarantee**	Premium deductible (the higher outside % the better)
Captive not owned by parent but by shareholders in different %'s	Premiums deductible
Captive sub in brother-sister structure, no parental guarantee	Premiums deductible
Captive sub in brother-sister structure with parental guarantee	Premiums not deductible
Captive sub in brother-sister structure with parental guarantee for small line of business	Premium for small line not deductible; remainder deductible
Captive sub in brother-sister	Premiums deductible

structure with parental guarantee
only for governmental regulation
and not for outside insurers

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* No parental guarantee to pay captives' liabilities (usually) to an outside insurance company.

** There are no cases with significant outside business and parental guarantees.

[1] Clougherty Packing Co., **84 TC 948** (1985), *aff'd* **59 AFTR 2d 87-668** , 811 F2d 1297, 87-1 USTC ¶9204 (CA-9. 1987); Mobil Oil Corp., **56 AFTR 2d 85-5636** , 8 Cl Ct 555, 85-2 USTC ¶9585 (Cls. Ct., 1985).

[2] Sears, Roebuck & Co., **96 TC 61** (1991), *aff'd* **70 AFTR 2d 92-5540** , 972 F2d 858, 92-2 USTC ¶50426 (CA-7, 1992) (75% outside business); AMERCO, **96 TC 18** (1991), *aff'd* AMERCO, Inc., **70 AFTR 2d 92-6048** , 979 F2d 162, 92-2 USTC ¶50571 (CA-9, 1992) (52% outside business); Harper Group and Includible Subs., 96 TC 45 (1991), *aff'd* **70 AFTR 2d 92-6053** , 979 F2d 1341, 92-2 USTC ¶50572 (CA-9 1992) (30% outside business); however, 2% not enough, Gulf Oil Corp., **66 AFTR 2d 90-5552** , 914 F2d 396, 90-2 USTC ¶50496 (CA-3, 1990).

[3] Humana Inc., **64 AFTR 2d 89-5142** , 881 F2d 247, 89-2 USTC ¶9453 (CA-6, 1989).

[4] Kidde Industries Inc., **81 AFTR 2d 98-326** , 40 Fed Cl 42, 98-1 USTC ¶50162 (Fed. Cl. Ct., 1997).

[5] Rent-A-Center, Inc., **142 TC No 1** , Tax Ct Rep (CCH) 59801, Tax Ct Rep Dec (RIA) 142.1, 2014 WL 128000 .

[6] However, **Reg. 1.162-1(a)** allows a business deduction for insurance expense.

[7] Helvering v. Le Gierse, **25 AFTR 1181** , 312 US 531, 85 L Ed 996, 41-1 USTC ¶10029, 1941-1 CB 430 (1941).

[8] Spring Canyon Coal Co., **9 AFTR 30** , 43 F2d 78, 2 USTC ¶574, 1930-2 CB 379 (1930); Steere Tank Lines, Inc., **42 AFTR 2d 78-5555** , 577 F2d 279, 78-2 USTC ¶9605 (CA-5, 1978).

[9] Carnation Co., **71 TC 400** (1978), *aff'd* **47 AFTR 2d 81-997** , 640 F2d 1010, 81-1 USTC ¶9263 (CA-9, 1981).

[10] Moline Properties, Inc., **30 AFTR 1291** , 319 US 436, 87 L Ed 1499, 43-1 USTC ¶9464, 1943 CB 1011 (1943).

[11] Under **Rev. Rul. 2001-31, 2001-1 CB 1348** , the IRS said it will no longer invoke the economic family theory.

[12] 1977-2 CB 53.

[13] Stearns-Roger Corp, Inc., 83-2 USTC ¶9731 (DC Colo., 1983).

[14] Note 8, *supra*.

[15] Stearns-Roger Corp., Inc., **56 AFTR 2d 85-6099** , 774 F2d 414, 85-2 USTC ¶9712 (CA-10, 1985).

[16] Beech Aircraft Corp., **54 AFTR 2d 84-6173** , 84-2 USTC ¶9803 (DC Kan., 1984).

[17] Beech Aircraft Corp., **58 AFTR 2d 86-5548** , 797 F2d 920, 86-2 USTC ¶9601 (CA-10, 1986).

[18] Crawford Fitting Co., **55 AFTR 2d 85-1071** , 606 F Supp 136, 85-1 USTC ¶9189 (DC Ohio, 1985).

[19] Note 1, *supra.*

[20] *Id.*

[21] *Id.*

[22] There were some liquidations and reorganizations, and at one time, two captive insurance subsidiaries, but none of that is relevant to the outcome of this case.

[23] *Gulf Oil Corp.*, **89 TC 1010** (1989).

[24] *Malone & Hyde, Inc.*, **TC Memo 1993-585** , RIA TC Memo ¶93585, 66 CCH TCM 1551 .

[25] See *Hospital Corporation of America,* **TC Memo 1997-482** , RIA TC Memo ¶97482, 74 CCH TCM 1020 , citing both limited availability and high prices.

[26] Carnation, *supra* note 9; Beech Aircraft, *supra* note 17.

[27] Note 15, *supra*.