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# MOBIL OIL CORP. V. UNITED STATES: CAPTIVE INSURANCE COMPANIES AND SECTION 162 OF THE INTERNAL REVENUE CODE

Thadeus J. MocarSKI\*

## INTRODUCTION

Captive offshore insurance companies are valuable business tools that offer multinational corporations significant tax and non-tax benefits.<sup>1</sup> A captive offshore insurance company is normally an offshore controlled corporation established by a multinational corporation either to insure or reinsure the risks of the parent corporation, domestic affiliates, and foreign affiliates.<sup>2</sup> Although the captive insurance company may be organized anywhere, it is usually organized in a tax haven country, such as Bermuda or the Bahamas, to take advantage of lenient tax laws and minimal insurance regulations.<sup>3</sup>

The use of a captive insurance company offers the parent corporation substantial non-tax benefits such as financial, management, and insurance advantages.<sup>4</sup> More importantly, however, are the potential tax benefits associated with captive insurance companies. The parent cor-

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1. See generally O'Brien & Tung, *Captive Off-shore Insurance Companies*, 31 INST. ON FED. TAX'N 665 (1973) (discussing captive offshore insurance companies and their tax benefits); Comment, *Federal Taxation Concepts in Corporate Risk Assumption: Self-Insurance, the Trust, and the Captive Insurance Company*, 46 FORDHAM L. REV. 781 (1978) [hereinafter Comment, *Concepts*] (analyzing captive insurance companies as an alternative to self-insurance and trusts as tools available to a corporation to effectively protect itself from risks).

2. Saggese, *Utilization of a Foreign Captive Insurance Corporation*, 644 INS. L.J. 525, 525 (1976). See generally 1 E. OWENS, INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION, PART TWO: 43-44 (1980) (describing foreign corporations as corporations incorporated outside of the United States).

3. See Note, *Revenue Ruling 77-316 and Carnation Co. v. Commissioner: An Analysis of the Attack on Captive Offshore Insurance Companies*, 2 VA. TAX REV. 111, 111 (1982) (discussing tax and non-tax advantages of offshore insurance operations); see also *infra* note 17 (discussing Bermuda tax laws and insurance regulations). See generally Saggese, *supra* note 2 (discussing the attraction of multinational corporations to Bermuda for establishment of foreign captive insurance corporations).

4. See O'Brien & Tung, *supra* note 1, at 667 (discussing business and tax advantages of captive offshore insurance companies). See generally Tinsley, *Why Revenue Ruling 77-316 is Wrong: A Captivating Argument*, 9 J. CORP. TAX'N 142 (1982) (stating that faults in the reasoning of Revenue Ruling 77-316 detracted from its credibility); Pine, *The Case for 'Captive' Insurers*, HARV. BUS. REV. Nov.-Dec. 1972, at 142, 143 (discussing the many benefits of establishing a captive insurance company).

poration's insurance premiums paid to the captive insurance company are deductible pursuant to section 162 of the Internal Revenue Code as a normal and necessary business expense.<sup>5</sup> Therefore, the significant tax and non-tax benefits render captive insurance companies popular insurance techniques.<sup>6</sup>

During the 1970's, Revenue Ruling 77-316<sup>7</sup> and the United States Tax Court holding in *Carnation Co. v. Commissioner*<sup>8</sup> restricted the deductibility of insurance premiums paid to certain captive insurance companies. The Internal Revenue Service and the Tax Court determined that a corporation's premiums to its captive insurance company constituted a payment from a member of the same economic family and created an invalid insurance contract.<sup>9</sup>

The economic family analysis conflicts with the separate corporate identity doctrine.<sup>10</sup> The separate corporate identity doctrine states that despite the captive insurance company status as a subsidiary of the insured parent corporation, the captive insurance company and its parent are two separate and distinct corporations.<sup>11</sup> The economic family analysis, however, assumes that a parent corporation cannot transfer the risk of loss to a subsidiary captive insurance company.

In *Mobil Oil Corp. v. United States*<sup>12</sup> the United States Claims

5. I.R.C. § 162 (West 1986); see *infra* note 26 (setting forth the contents of section 162).

6. See Note, *supra* note 3, at 111 (describing the various tax and non-tax benefits derived from offshore captive insurance companies).

7. Rev. Rul. 77-316, 1977-2 C.B. 53. See generally M. SALTZMAN, IRS PRACTICE AND PROCEDURE, 3-16 - 3-17 (1981) (reciting the use and applicability of Revenue Rulings). Revenue rulings are interpretations and applications of the tax laws by the Internal Revenue Service. The rulings are applied to specific sets of facts to advise others on substantive tax issues. *Id.* Rulings, however, do not have the force and effect of the Internal Revenue Code or Treasury Regulations. *Id.* Instead, the rulings are drawn from letter rulings provided to taxpayers, technical advice to district offices, studies undertaken by the Assistant Commissioner, court decisions, suggestions from tax practitioner groups, and publications. *Id.* Their precedential value, therefore, is limited to situations where the facts are substantially the same as those set forth in the ruling. *Id.*

8. *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), *aff'd*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981).

9. Rev. Rul. 77-316, 1977-2 C.B. 53, 54; see also *Carnation Co. v. Commissioner*, 71 T.C. 400, 409 (applying a risk-shifting analysis similar to that found in Revenue Ruling 77-316), *aff'd*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981). There were no valid insurance payments because no risk of loss shifted within the insured corporation. The risk of loss must shift between the insured and insurer for a business expense deduction to be valid. *Id.*

10. See *infra* notes 73-83 and accompanying text (developing a description of the corporate entity doctrine).

11. See *infra* notes 73-88 and accompanying text (discussing the separate corporate entity doctrine).

12. *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555 (1985).

Court adopted the economic family analysis, disallowing captive insurance company tax benefits to a parent corporation.<sup>13</sup> If a parent corporation wishes to continue claiming income tax deductions for premiums paid to a captive insurance company, its captive insurance company must conform to the standards enunciated in *Mobil Oil*.<sup>14</sup> The Claims Court, however, did not reconcile its opinion with the separate corporate entity doctrine.

This note posits that the economic family analysis, incorrectly ignores many valid business reasons to operate captive insurance companies.<sup>15</sup> Section One describes the elements of a captive insurance company and discusses the arguments supporting and rejecting a captive's use. Section Two outlines the deductibility of premiums paid to captive insurance companies through the economic family analysis. Section Three discusses the corporate entity doctrine and its relevance to captive insurance companies. Section Four details the courts' treatment of captive insurance companies, analyzing the cases leading up to *United States v. Mobil Oil Corp.* Section Five describes the *Mobil Oil* decision and Section Six concludes that the court failed to reconcile its adoption of the economic family analysis with the separate corporate identity doctrine.

## I. ELEMENTS OF CAPTIVE OFFSHORE INSURANCE COMPANIES

### A. STRUCTURE OF CAPTIVE OFFSHORE INSURANCE COMPANIES

A parent corporation forms a captive insurance company as its subsidiary.<sup>16</sup> Normally, the parent incorporates a captive insurance company in a foreign jurisdiction that maintains lenient laws concerning the regulation and taxation of insurance companies.<sup>17</sup> After a captive

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13. *Id.* at 568.

14. *Id.*

15. See *infra* notes 152-71 and accompanying text (stating that the separate corporate identity doctrine should be employed to determine risk shifting rather than the economic family test).

16. See Comment, *Concepts, supra* note 1, at 811 (discussing the relationship between captive insurance companies and parent corporations).

17. See generally 1 D. DIAMOND & W. DIAMOND, *TAX HAVENS OF THE WORLD* (1986) (discussing tax exemptions and reductions and investment and capital incentives for foreign captive insurance companies in Bermuda). In Bermuda, for example, there is no income tax or capital gains tax. *Id.* at 1. Also, there are no taxes on dividends paid in or remitted from Bermuda. *Id.*

The only tax payable is in the form of a government fee of \$1,200 payable on incorporation and \$1,200 paid annually by all exempted companies. See B. SPITZ, *TAX HAVENS ENCYCLOPEDIA* 4 (1983) (discussing the legal status of and procedure for exempted and non-resident corporations in Bermuda). Each fee, however, increases to

insurance company is incorporated, its parent contributes to the captive insurance company's capital.<sup>18</sup> To carry out the capitalization the parent transfers cash assets to the captive insurance company.<sup>19</sup> Following the capitalization, the parent either directly insures itself through the captive insurance company, or acquires an insurance policy from an unaffiliated insurance company that reinsures the majority of the risk of the parent's risk with the captive insurance company.<sup>20</sup>

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\$2,500 in the case of insurance companies. D. DIAMOND & W. DIAMOND, *supra*, at Bermuda 2.

Exempted companies are companies incorporated in Bermuda transacting business elsewhere in the world. B. SPITZ, *supra*, at BE2. An exempted company is entitled under the Exempted Undertakings Tax Protection Act to special protection from the Bermuda government. D. DIAMOND & W. DIAMOND, *supra*, at Bermuda 1. The Act provides that if the government should ever impose any tax on profits, income, capital assets, gains, or appreciation such taxes will not be applicable to an authorized company until March 28, 2006. *Id.*

Besides the absence of income taxation, Bermuda maintains minimal regulations concerning insurance companies. On July 7, 1978, the Bermuda Insurance Act of 1978 was passed (effective February 1980) regulating insurance business practiced in Bermuda. *Id.* at 10. It applies to local insurance companies, non-resident insurance companies, and exempted insurance companies. B. SPITZ, *supra*, at BE2. Of these three categories, captives are a form of exempted insurance companies. *Id.*

For a captive insurance company to engage in business from within Bermuda, it first must register with the Minister of Finance as both an insurance company and a corporation. *Id.* After registration it is required that all registered insurance companies maintain a principal office and representative in Bermuda. *Id.* Each of these insurance companies also must file an annual financial return with the Registrar of Companies to serve as a short summary of the insurance company's accounts. *Id.*

The Insurance Act requires corporations forming captive insurance companies in Bermuda to demonstrate that the insurance company will be able to conduct a legitimate insurance business. D. DIAMOND & W. DIAMOND, *supra*, at Bermuda 10. To demonstrate the captive insurance company's legitimacy, the captive's assets must exceed liabilities by the amounts specified in the regulations. *Id.* If such a surplus is not maintained, the captive will be declared insolvent and will be forced to close its business. *Id.*

Paid-in capital to the captive insurance companies also is governed by the Insurance Act. *Id.* The paid-in capital of captive must be at least \$120,000 for general business, \$250,000 for long-term business, and \$370,000 for both types of business. *Id.* In addition, the Bermuda Insurance Act does not specifically mention that a captive must maintain a premium to surplus ratio as required in American jurisdictions. *Id.*

18. See *infra* notes 135-40 and accompanying text (describing the methods Mobil Oil used to make capital contributions to its newly-created captive insurance company).

19. See *infra* notes 92-98 and accompanying text (discussing the capitalization process of the captive insurance company in *Carnation Co. v. Commissioner*).

20. See generally S. KIMBALL & W. PFENNIGSTORF, *THE REGULATION OF INSURANCE COMPANIES IN THE UNITED STATES AND THE EUROPEAN COMMUNITIES: A COMPARATIVE STUDY* 40 (1981) (discussing special rules for reinsurers licensed in the United States). This differs from the typical insurance process where an insured has a direct insurance policy with an insurer. *Id.*

## B. PURPOSES AND BENEFITS OF ESTABLISHING CAPTIVE OFFSHORE INSURANCE COMPANIES

A parent creates a captive insurance company to reduce insurance costs and to increase insurance coverage.<sup>21</sup> Normally, reduced insurance cost means reduced insurance coverage.<sup>22</sup> Captive insurance companies, however, reverse this trend, allowing an insured to reduce insurance costs and simultaneously increase its insurance coverage.<sup>23</sup>

Many major corporations operate some form of captive insurance system to insure the parent corporation's risks and take advantage of the significant economic benefits.<sup>24</sup> Benefits are classified into two categories, either tax or non-tax benefits. The potential tax benefits of establishing a captive insurance company are of great importance to many corporations. These benefits originate in the Internal Revenue Code, section 162.<sup>25</sup> Section 162 designates insurance premiums as potential deductible expenses.<sup>26</sup> A business expense, like an insurance premium, is deductible if it is incurred in the trade or business, is not a capital expenditure, and is ordinary and necessary.<sup>27</sup>

Many corporations organize captive offshore insurance subsidiaries for sound non-tax business reasons.<sup>28</sup> Their reasons include: (a) lower

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21. Comment, *Concepts, supra* note 1, at 811; see D. DIAMOND & W. DIAMOND, *supra* note 17, at Bermuda 4-5 (listing tax and non-tax benefits available to offshore insurance operations).

22. See *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 556-63 (1985) (analyzing Mobil Oil's problem of facing rising insurance costs to cover its risks and a need to reduce insurance costs to reduce expenditures). In an insurance contract, an insurer and potential insured determine a premium the insured must pay in order to receive insurance for some future loss. W. VANCE & B. ANDERSON, *VANCE ON INSURANCE*, 65-66 (1964). This premium is determined so that the insured's premium reflects the probability of loss in conjunction with the total property insured. *Id.* at 67. Therefore, if an insured's property's value is high, the insured will pay higher premiums to insure the property. *Id.*

23. Comment, *Concepts, supra* note 1, at 811.

24. See D. DIAMOND & W. DIAMOND, *supra* note 17, at Bermuda 3-5 (acknowledging that the multitude of benefits available to offshore insurance operations inspired many American corporations to create their own captive insurance companies).

25. I.R.C. § 162 (West 1986).

26. See I.R.C. § 162(a) (West 1986) (stating that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business"); see also Treas. Reg. § 1.162-1 (1975) (including in the definition of business expenses: management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business, advertising, and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar loss in the case of a business, and rental for the use of a business property).

27. 2 STAND. FED. TAX REP. (CCH) D 162, 1330.015 (1986).

28. See generally Pine, *supra* note 4 (describing a captive insurance company, with adequate premium income, that has the ability to reduce corporate insurance expenses

insurance premiums,<sup>29</sup> (b) freedom from domestic statewide regulations affecting the captive's operations and portfolio investments,<sup>30</sup> (c) centralization of worldwide insurance coverage for multinational corporations,<sup>31</sup> (d) coverage of commercially uninsurable risks,<sup>32</sup> (e) centralization of corporate funds for investment expansion,<sup>33</sup> (f) greater flexibility in creating unique insurance policies,<sup>34</sup> and (g) greater accessibility to international reinsurance markets.<sup>35</sup>

A party enters into an insurance contract to indemnify against loss, damage, or liability arising from an unknown or contingent event.<sup>36</sup>

without the loss of underwriting profits or investment income).

29. See *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 557 (1985) (acknowledging the cost savings to Mobil Oil for using a captive insurance company for insurance purposes).

30. See S. KIMBALL & W. PFENNIGSTORF, *supra* note 20, at 40 (noting that control of reinsurance by the states within the United States is limited). The transaction between the direct insurer, which may itself be a foreign insurer, and the reinsurer, often takes place outside the state where the insured risk is located. Consequently, the state is concerned less in this case than in the case of a direct insurance transaction. *Id.*

31. See generally *id.* at 21 (portraying American insurance law as inconsistent and minimally coherent, resulting in poorly structured American insurance regulations that prompt corporations to insure all of their risks in a jurisdiction with predictable laws and standards).

32. O'Brien & Tung, *supra* note 1, at 668. For companies operating in high hazard industries such as airline, oil, and chemical companies, insurance premiums are much higher than for low risk companies. *Id.* at 667. Consequently, companies in high hazard industries are forced to use another means of insuring risks because complete risk transfer to an unrelated insurer is often impossible. See *Mobil-Oil Corp. v. United States*, 8 Cl. Ct. 555, 557 (1985) (noting that Mobil Oil incorporated a captive insurance company to provide fuller insurance coverage in light of the high risks involved with the oil business).

33. O'Brien & Tung, *supra* note 1, at 668. The captive insurance company may lend the capital received as premium payments back to the parent or subsidiary at low interest rates. Through this practice, a corporation has more funds at its disposal for investment purposes. *Id.* Such investment purposes include reinvestment in the corporation or investments outside of the corporation. *Id.* The central fact is that the same monies are used twice: once to pay an insurance premium, and again for investment. See *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 559-60 (1985) (finding that at least 50 percent of the money held by Mobil Oil's captive as insurance premiums and insurance reserves was recommitted to Mobil Oil interests).

34. See *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 557 (1985) (recognizing that Mobil Oil's use of a captive insurance company was due in part to the need for different types of insurance coverage to centralize its risk management schedule).

35. O'Brien & Tung, *supra* note 1, at 668. By gaining access to the international reinsurance market, the captive further reinsures the parent's policy. *Id.* The captive may buy such an international reinsurance policy at wholesale rates. *Id.* Although cost savings in this area are not guaranteed, more flexibility is permitted in creating an insurance policy to fit the needs of the parent corporation. See *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 557 (1985) (noting that Mobil Oil incorporated its captive insurance company to provide more flexible insurance coverage to itself and its affiliates).

36. See *United States v. Newton Livestock Auction Mkt., Inc.*, 336 F.2d 673, 676 (10th Cir. 1964) (defining insurance as a contractual relationship between an insurer

The courts interpret section 162 to hold that a party cannot deduct as business expenses funds set aside in anticipation of losses, such as self-insurance reserves, because establishing liability has yet to occur.<sup>37</sup> The Internal Revenue Service agreed with the courts and set forth Revenue Ruling 69-512, disallowing deductions for self-insurance reserves.<sup>38</sup> Therefore, to deduct insurance payments a party must make these payments to another party covering an identifiable risk.<sup>39</sup> This constitutes the risk shifting concept.<sup>40</sup>

A parent corporation establishes a captive insurance company to satisfy Revenue Ruling 69-512. The Internal Revenue Service, however, attacks the deductibility of premiums paid to captive insurance companies, arguing that no risk shifts when a parent corporation pays a premium to its subsidiary.

## II. INTERNAL REVENUE SERVICE APPROACHES DEDUCTING INSURANCE PREMIUMS PAID TO CAPTIVE OFFSHORE INSURANCE COMPANIES

### A. INSURANCE PREMIUMS

The Internal Revenue Service viewed captive insurance companies as a means for a corporation to exaggerate their business expense deductions. In response to the growth of foreign captive insurance compa-

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and insured whereby the insured's risk of loss shifts to the insurer); W. VANCE & B. ANDERSON, *VANCE ON INSURANCE* 82 (1964) (defining a contract of insurance as "any contract by which one of the parties for a valuable consideration, known as a premium, assumes the risk of loss or liability that rests upon the other").

37. *Spring Canyon Coal Co. v. Commissioner*, 43 F.2d 78, 79-80 (10th Cir.), *cert. denied*, 284 U.S. 654 (1931). The court distinguished between insurance premiums and payments to a self-insurance reserve, noting that the whole object of self-insurance is to avoid the expense of insurance premiums. *Id.* If a taxpayer elects to insure its risks with a private insurance company, it will pay a premium in order to shift the risk. *Id.* at 80. If a taxpayer elects not to expend a premium, it cannot charge a corresponding sum as an expense because it retained the risk and kept the premium. *Id.* Expenses incurred and deductible are sums paid, not amounts set aside for protection. *Id.*; *see also Steere Tank Lines, Inc. v. United States*, 577 F.2d 279, 280 (5th Cir. 1978) (prohibiting deductions for payments to a self-insurance fund).

38. Rev. Rul. 69-512, 1969-2 C.B. 24 (holding that reserves established for self-insurance are not ordinary and necessary expenses paid in the course of carrying on a business and therefore, not deductible).

39. *Steere Tank Lines, Inc. v. United States*, 577 F.2d 279, 280 (5th Cir. 1978) (stating that only through a payment to an insurer is liability shifted from the insured party to the insurer). The payment from party A to party B to protect party A from an identifiable risk constitutes an essential element of insurance. *Id.* This differs from the self-insurance system where insurance payments are retained by the insured party. *Id.*

40. *See infra* notes 44-48 and accompanying text (describing risk shifting as defined for insurance purposes).



nies<sup>41</sup> the Internal Revenue Service developed the idea that insurance premiums paid by a parent to a captive insurance corporation are not deductible as ordinary and necessary business expenses.<sup>42</sup> Seeking to deny corporations this tax deduction, the Internal Revenue Service used the risk shifting doctrine to attack the deduction of premiums paid to captive insurance companies.<sup>43</sup>

## B. RISK SHIFTING

For federal tax purposes, the concept of defining insurance as a transfer of risk began with the Supreme Court's decision in *Helvering v. Le Gierse*.<sup>44</sup> In *Le Gierse*, the respondent received proceeds from a decedent's life insurance and annuity contracts.<sup>45</sup> Pursuant to the tax code in effect at the time, proceeds from insurance were excluded from the estate tax. To avoid paying taxes, the respondent attempted to classify the life insurance and annuity contract proceeds as insurance.<sup>46</sup> The Supreme Court held that if the insurance policy in question did not involve risk shifting, no insurance exists.<sup>47</sup> Viewing the life insurance policy and annuity contract together, the Supreme Court found no risk transferred.<sup>48</sup>

Although *Le Gierse* defined insurance in the context of life insurance policies and annuity contracts, the Internal Revenue Service applied this definition of insurance to determine the tax consequences for insur-

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41. D. DIAMOND & W. DIAMOND, *supra* note 17, at Bermuda 1-3. It was reported that in 1978, Bermuda alone has over 700 captive offshore insurance companies and this increase came after a growth of almost 400 companies over the past four years. *Id.* In addition, the 700 captive insurance companies present in 1978 were writing approximately 2.5 billion dollars in premiums. Bergson, *Captive Insurers Slip Their Chains*, N.Y. Times, July 16, 1978, § 3 at 1, col. 1. By the end of 1985, the premium value of Bermuda foreign-based insurance companies was expected to exceed 9.5 billion dollars, and this figure represents approximately thirty-five percent of the island's national product. D. DIAMOND & W. DIAMOND, *supra* note 17, at Bermuda 9.

42. Rev. Rul. 77-316, 1977-2 C.B. 53, 54.

43. See O'Brien & Tung, *supra* note 1, at 674-92 (discussing various approaches available to the Internal Revenue Service to rebut the legitimacy of deductions for insurance premiums paid to captive insurance companies).

44. *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

45. *Id.* at 537.

46. See *id.* at 538-39 (noting that the tax code at the time of this case had never defined insurance in this context, forcing the Supreme Court to develop such a definition).

47. *Id.* at 536-37.

48. See *id.* at 539 (stating that historically and in common practice, insurance involves risk shifting and risk distribution); see also *Carnation Co. v. Commissioner*, 71 T.C. 400, 408 (1978), *aff'd*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981) (noting the importance of *Helvering v. Le Gierse* in the creation of the risk shifting definition of insurance and that any type of annuity or insurance agreement must be scrutinized to determine if risk shifting is present).

ing through a captive insurance company. The Internal Revenue Service clarified its position in Revenue Ruling 60-275,<sup>49</sup> stating that to deduct an insurance premium as a business expense under section 162, the premium must be paid pursuant to a "true" insurance contract.<sup>50</sup> Revenue Ruling 60-275 permits deducting an insurance premium if paid to an unaffiliated insurance company or similarly unrelated body and if it shifts the risk from the insured party.<sup>51</sup> Therefore, a taxpayer who sets aside money equivalent to an insurance premium for self-insurance cannot deduct the set aside as an expense paid or incurred.<sup>52</sup>

The Internal Revenue Service treated payments to a captive insurance company not as premiums but as non-deductible capital contributions from the parent corporation to the subsidiary captive insurance company. In effect, the Internal Revenue Service viewed payments to a captive insurance company, wholly-owned by the parent corporation, indistinguishable from payments made to a self-insurance reserve.<sup>53</sup>

49. Rev. Rul. 60-275, 1960-2 C.B. 43.

50. See *id.* at 45 (stating that a "true" insurance contract may exist only if risk shifting is present).

51. *Id.*

52. See Treas. Reg. § 1.801-3(a) (1975) (defining insurance company for federal income tax purposes). For purposes of the Internal Revenue Code, an insurance company is defined as:

A company whose primary purpose during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Though subject to state laws, it is the character of the business actually done on the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

*Id.* In addition, a business enterprise has three methods of protecting itself from risks: retain the risks by using a form of self-insurance, prevent the formation of risks and transfer the risks by use of an insurance policy. O'Brien & Tung, *supra* note 1, at 681.

53. Rev. Rul. 60-275, 1960-2 C.B. 43, 45. *But see* I.R.C. § 269(a) (West 1985) (presenting an alternate approach towards disallowing deductions paid as premiums to captive insurance companies). Section 269 states:

If any corporation acquires the property of another corporation, such property not being controlled immediately before the acquisition by the acquiring corporation, with the principal purpose in mind to evade Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance.

*Id.*; Internal Revenue Service, *Captive Offshore Insurance or Reinsurance Companies*, 2 INT. REV. MAN.—AUDIT, (CCH) D 8215-2 (1980) (directing auditors to disallow deductions for premiums paid foreign captives by virtue of sections 482 and 269).

The court in *Alinco Life Ins. Co. v. United States*, 373 F.2d 336 (Ct. Cl. 1967) discounted this analysis of captive insurance companies. *Alinco* involved a reinsurance relationship between a primary insurer and Alinco, where Alinco reinsured eighteen percent of the primary insurer's risks. *Id.* at 239. The court concluded that several valid business motives supported the creation of Alinco and did not accept a section 269 approach towards the deductibility of insurance premiums retained by Alinco. See *id.* at 343 (holding that even a major motive to reduce taxes will not vitiate an otherwise valid and real business transaction).

The Internal Revenue Service used the economic family analysis to determine that a parent corporation's payment to a captive insurance company did not constitute risk shifting. Revenue Ruling 77-316,<sup>54</sup> first setting forth the economic family analysis, analyzed three scenarios for a corporation to establish a captive insurance company.<sup>55</sup> The Internal Revenue Service concluded that in all three scenarios the risk of loss did not shift from the parent corporation to the captive insurance company.<sup>56</sup> Therefore, without insurance *per se* the premium payments were not deductible.<sup>57</sup>

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The Alinco parent corporation successfully demonstrated valid non-tax purposes for operating a captive insurance company. *See id.* at 345 (stating that because Alinco demonstrated sufficient business purposes, Alinco should not be subject to section 269 for tax advantages that also flowed from the same transaction). Assuming such purposes are demonstrable, the Internal Revenue Service must show then that tax avoidance is the captive's primary purpose. *See id.* at 341 (discussing the Internal Revenue Service contention that the principle purpose in the transaction described in this case was tax avoidance). The decision in *Alinco* made the Internal Revenue Service's attack on section 269 less viable, thus lightening the burden on captive insurance companies. *Id.*

54. Rev. Rul. 77-316, 1977-2 C.B. 53, 54 (noting that, pursuant to Section 162, the Internal Revenue Service considered whether premiums paid by the parent corporation and its subsidiaries to a wholly-owned captive insurance company were deductible as business expenses).

55. *Id.* at 54. In the first scenario corporation X organized a wholly-owned foreign insurance subsidiary known as S1. *Id.* at 53-54. X contracted with S1 to insure the properties and risks of X and its domestic subsidiaries. Premiums from this insurance contract reflected standard commercial insurance rates and flowed directly to S1. The S1 captive insured no other risks, apart from those of X and its subsidiaries. *Id.*

The facts in the second scenario parallel those in the first except that X paid insurance premiums to cover its risks and properties to M, an unrelated domestic insurance company. *Id.* at 54. X entered into an insurance arrangement with M under a contract which provided that M would reinsure 95% of the risks with S2, the wholly-owned foreign insurance captive of X. In the contractual agreement between S2 and M, M maintained its primary insurer position as to X. *Id.*

The final scenario is comprised of many of the same facts as in the first scenario. *Id.* In this case, however, X paid insurance premiums to its wholly-owned foreign insurance subsidiary known as S3. S3 entered into a contract with W, an unrelated insurance company. Under this contract, S3 agreed to transfer 90% of the risk to W through reinsurance agreements. *Id.*

Using these scenarios, the Internal Revenue Service delivered its opinion concerning the deductibility of premiums paid to captive insurance companies that is still the standard today. The Internal Revenue Service ruled that amounts paid to S1, S2, and S3 as insurance premiums when retained by these captives, are not deductible as valid business expenses under section 162. *Id.*

56. *Id.* at 54-55. In all three captive insurance scenarios, the Internal Revenue Service determined that the parent corporation and its captive insurance company subsidiary were members of a single economic family. *Id.* Because these corporations were within the same economic family, any insurable loss incurred by the parent corporation would ultimately be borne by the parent corporation. *Id.* The premium payments to the captive insurance company were interpreted as transfers of capital from a parent corporation to its subsidiary. *Id.* Therefore, there was no risk shifting. *Id.*

57. *Id.* at 53-54. The amounts not insured by S2 in scenario 2 (5%), and the

The economic family<sup>58</sup> analysis asserts that movements of cash among an economic family comprised of closely held corporations<sup>59</sup> are essentially movements of cash among one corporate network.<sup>60</sup> In Revenue Ruling 77-316's three scenarios, the parent corporation that formed the captive insurance company was ultimately responsible for its loss because the money used to cover the loss came from within the corporate network. Therefore, according to the Internal Revenue Service, the risk of loss was not transferred from one separate entity to another but from one part of a separate entity to another part.

Revenue Ruling 77-316 states a valid insurance contract exists only when the risk of loss shifts to an unrelated party. Divided into five factors, the economic family analysis determines whether the insurer and the insured are unrelated parties.

Factor one evaluates whether the captive insurance company maintains adequate capitalization.<sup>61</sup> If a captive insurance company does not have the financial capacity to cover losses, arising from a parent corporation's or its subsidiaries' claims, then no risk transfers. Further, the captive insurance company must possess sufficient financial resources to fulfill its contractual obligations. Otherwise, the parent corporation reimburses itself for its losses, and the insurance contract is illusory.<sup>62</sup>

Factor two evaluates whether the captive insurance company maintains a level of capitalization and assets consistent with the risks insured.<sup>63</sup> Low capitalization raises questions concerning a captive's via-

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amount transferred by S3 in scenario 3 (90%), are deductible under Section 162 of the Internal Revenue Code. See *supra* note 26 and accompanying text (describing deductible insurance costs of Section 162). Because these amounts are no longer in the economic control of X and represent a distribution of a percentage of the risk to unrelated insurers, they are considered paid or incurred pursuant to Section 162. Rev. Rul. 77-316, C.B. 53, 54.

58. See generally Note, *Revenue Ruling 77-316*, *supra* note 3, at 111 (classifying captive offshore insurance companies, subsidiaries, and the parent as one economic family and therefore, unable to properly distribute the risk of loss).

59. See H. HENN & J. ALEXANDER, *LAWS OF CORPORATIONS* 694 (3d ed. 1983) (defining a closely held corporation as one whose shares are held by either a single shareholder or a closely knit group of shareholders).

60. Rev. Rul. 77-316, 1977-2 C.B. 53, 55.

61. See *Carnation Co. v. Commissioner*, 71 T.C. 400, 409 (1978), *aff'd*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981) (stating that a focal point in the case was Carnation's promise to provide \$3 million for capitalization of its captive insurance company).

62. See *Stearns-Roger Corp. v. United States*, 577 F. Supp. 833, 838 (D. Colo. 1984), *aff'd*, 774 F.2d 414 (10th Cir. 1985) (finding that if the insurance agreements do not shift the risk of loss, evidenced by proper capitalization of the captive insurance company, the insurance agreement is invalid for federal tax purposes).

63. See N.Y. INS. LAW § 47 (McKinney 1985) (establishing as a minimum capital-

bility as a valid insurance company.<sup>64</sup> To eliminate these questions, a captive's capitalization must comply with current insurance company standards.<sup>65</sup>

Factor three evaluates whether the captive protects its solvency through procurement of reinsurance.<sup>66</sup> Reinsurance supports the captive insurance company's position as a bona fide insurance company.<sup>67</sup> Furthermore, reinsurance makes the captive insurance company's risk consistent with its premiums and capital position. Acting as a bona fide insurance company and not as a tool of the parent corporation, the captive insurance company exists outside the parent corporation's economic family. This analysis supports the conclusion that the risk of loss transfers from the parent corporation to the captive insurance company.<sup>68</sup>

Factor four evaluates whether the premium the captive charges puts the captive and the parent corporation in a market relationship.<sup>69</sup> If the insurance premiums the parent corporation pays to the captive insurance company force the captive insurance company to operate at a loss, the captive may be viewed as part of the parent's economic family.<sup>70</sup> If operating at a profit, however, the captive insurance company operates in a market relationship with the parent and therefore exists outside the parent's economic family.

Finally, factor five evaluates whether the captive insurance company controls its assets.<sup>71</sup> If the parent or its subsidiaries may withdraw the premiums payable to the captive insurance company, these premiums

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ization requirement that no insurer expose itself to a loss on any risk exceeding ten percent of its surplus to policy holders).

64. See *infra* note 160 and accompanying text (setting forth the importance of adequately capitalizing a corporation).

65. *Id.*

66. See Kloman, *Captive Insurance Companies—1977*, 4 RISK MGMT. REP. 6, 6 (1977) (discussing, as being indicative of the captive's economic independence, instances in which an unrelated insurance company is willing to offer coverage to the captive).

67. *Id.* at 6. It is customary for insurance companies to acquire reinsurance for risks already insured. Therefore, if the captive insurance company actively seeks reinsurance, it is demonstrating that it is acting in the normal fashion for an insurance company. *Id.*

68. If the captive insurance company is operating at a loss, it may appear that the parent corporation is maintaining the captive solely for insurance tax benefits. The presence of profits, however, may be deceptive if the parent maintains control over the captive's assets.

69. See Treas. Reg. 1.482-1(d)(3) (1975) (finding a market relationship if the premium actually charged is identical to the premium charged in a transaction between two unrelated parties under similar circumstances).

70. Rev. Rul. 77-316, 1977-2 C.B. 53, 54.

71. *Id.* at 55.

become a tool for transferring assets within the economic family. The economic family retains the funds rather than shifting them to a body outside the family. Therefore, the risk does not transfer.<sup>72</sup> Use of the economic family analysis, however, ignores the implications of the corporate entity doctrine.

### III. THE CORPORATE ENTITY DOCTRINE

#### A. PRINCIPLES OF THE CORPORATE ENTITY DOCTRINE

The corporate entity doctrine posits that affiliated corporations are entities wholly independent of their shareholders for tax purposes rather than groups dependent upon the identity and behavior of the shareholders.<sup>73</sup> According to this doctrine, a subsidiary corporation is considered an independent entity for federal income tax purposes.<sup>74</sup> The doctrine asserts that corporations are independent tax paying entities for purposes of the Internal Revenue Code and unaffected by the identity and principal characteristics of its shareholders.<sup>75</sup> This rule was set forth by the Supreme Court in *Moline Properties, Inc. v. Commissioner*.<sup>76</sup>

In *Moline Properties*, the corporation's sole stockholder of a corporation attempted to report the gains from a sale of the corporation's real estate as his own.<sup>77</sup> The corporation maintained no books or bank accounts under the corporate name.<sup>78</sup> In accordance with the corporate entity doctrine, the Court considered the corporation a separate taxable

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72. See *Helvering v. Le Gierse*, 312 U.S. 531 (1941) (requiring the risk to transfer); Rev. Rul. 77-316, 1977-2 C.B. 53, 55 (stipulating that risk must transfer).

73. See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, D 1.05, 1-14-1-22 (4th ed. 1979) (analyzing the corporate entity doctrine and stating that, in general, the corporation is treated as an independent tax-paying entity by the Internal Revenue Service, unaffected by the personal characteristics of its shareholders).

74. See *Raffety Farms, Inc. v. United States*, 511 F.2d 1234, 1235 (8th Cir.), cert. denied, 423 U.S. 834 (1975) (recognizing independent entity status despite the use of corporate form to avoid a foreign law, and stressing that if the corporation is used to serve the "creator's personal or undisclosed convenience, but such purpose is equivalent of business activity or it is followed by carrying on of business, then the corporation remains a separate taxation unit").

75. B. BITTKER & J. EUSTICE, *supra* note 73, at 1-14.

76. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-39 (1943). In this case, an individual created a corporation to be used as a security device in connection with certain realty he owned. *Id.* at 437. A portion of his property assigned within the corporation was leased for use as a parking lot. *Id.* at 438. The individual tried to claim the profit from the lease as gain on his individual return, but the Supreme Court ruled against him. *Id.* at 441.

77. *Id.* at 438.

78. *Id.*

entity.<sup>79</sup> Although the corporation remains a tool of the stockholder, under the corporate entity doctrine it still retains a separate identity.<sup>80</sup>

The corporate entity rule, however, is not absolute. In some cases, the substance of a corporation's transactions control over the form. Accordingly, the Internal Revenue Code contains various exceptions to the corporate entity rule.<sup>81</sup> To determine whether a transaction between a parent corporation and its subsidiary is between two separate corporations, a court should examine several factors.<sup>82</sup> If it appears that the subsidiary is not engaged in some independent industrial, commercial,

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79. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-39 (1943). The Court described the separate corporate entity doctrine as fulfilling a useful purpose in business life. *Id.* Whether the purpose is to: gain an advantage under the law of the state of incorporation, comply with the demands of creditors, serve the creator's personal, or undisclosed convenience, as 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. *Id.*; see also *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 430 (1949) (determining that corporate ownership and the control incident to it has no different tax consequences when clothed in the garb of agency than when worn as a removable corporate veil).

80. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943). As long as the purpose of incorporation 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. *Id.*

81. B. BITTKER & J. EUSTICE, *supra* note 73, 1-15; see I.R.C. § 269 (West 1985) (disallowing certain tax benefits if control of a corporation is acquired for the principal purpose of tax avoidance); I.R.C. § 531 (West 1986) (imposing an additional tax on corporations formed for the purpose of avoiding income tax on its shareholders by accumulating rather than distributing its earnings); I.R.C. § 341(e)(5)(A) (West 1986) (allowing for treatment of a corporation's assets as non-capital assets if they would have this character in the hands of a shareholder); I.R.C. § 1501 (West 1986) (permitting certain affiliated groups of corporations to file a consolidated return).

See generally *Higgins v. Smith*, 308 U.S. 473 (1949) (discussing that a taxpayer is free to adopt any organization of his affairs as he may choose, and if he elects to do business as a corporation he must accept the tax disadvantages). The government, nevertheless, is not required to acquiesce in the taxpayer's election of that form for doing business if it is most advantageous to the taxpayer. If the government determines that the form employed of doing business or carrying out the tax event is unreal or a sham, it is free to disregard the form of the established business organization and tax it, based then on its substance so that it best serves the purposes of the tax statutes. *Id.* at 477.

82. See B. BITTKER & J. EUSTICE, *supra* note 73, at 1-14-1-22 (discussing the factors determining when a transaction is at arm's length); O'Brien & Tung, *supra* note 1, at 686-87 (discussing the characteristics of an arm's length transaction). Such factors include reviewing the subsidiary's books, records, and other business information in order to determine how the business operations are handled, how much independence from the parent exists, whether the subsidiary is treated as a separate entity by the shareholders, and whether the subsidiary's premiums are consistent with a profit-making motive. *Id.* at 686. Also, the determination of a corporate entity involves the assignment of earned income, the substance of an act over its form, its relative business purposes and the integrative perspective of the step transactions. B. BITTKER & J. EUSTICE, *supra* note 73, at 1-18-1-22. Finally, if the subsidiary has no management responsibilities, it may be inferred that the captive corporation is acting only as an agent or nominee of the parent. *Id.*

or business activity, the court may rule the subsidiary lacks independence and refuse to regard it as a separate corporate entity.<sup>83</sup>

#### B. RELEVANCE OF THE CORPORATE ENTITY DOCTRINE TO CAPTIVE INSURANCE COMPANIES

The Internal Revenue Service relies exclusively on the economic family concept to disallow the deduction of insurance payments to captive insurance companies.<sup>84</sup> Its reliance, however, fails to recognize adequately the captive's independent corporate entity.<sup>85</sup> Rather, the Internal Revenue Service focuses exclusively on the economics of the captive-parent relationship.<sup>86</sup> Under the economic family analysis, the insured parent corporation must rid itself of any economic stake in its anticipated losses. Only then will the captive insurance company appear outside of the parent corporation's economic family and capable of bearing the risks of loss shifted from the parent corporation to itself.

The corporate entity doctrine conflicts with the economic family analysis. Pursuant to the corporate entity doctrine, premiums paid by a parent corporation to its captive insurance company shift the risk of loss unless a corporate entity doctrine exception applies. Revenue Ruling 77-316 does not characterize captive insurance companies as separate exceptions to the corporate entity doctrine. Rather, the Internal Revenue Service merely acknowledges the Supreme Court's acceptance of the doctrine in *Moline Properties*.<sup>87</sup> The Court's interpretation of the corporate entity doctrine, in *Moline Properties*, remains valid law and warrants closer Internal Revenue Service attention to the question of risk transfer from parent to captive insurance company.<sup>88</sup>

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83. *National Inv. Corp. v. Hoey*, 144 F.2d 466, 467-68 (2d Cir. 1944), quoted in B. BITTKER AND J. EUSTICE, *supra* note 73, at 1-17.

84. Rev. Rul. 77-316, 1977-2, C.B. 53, 54-55.

85. See *id.* (failing to fully state why the separate corporate entity doctrine was not applied in Revenue Ruling 77-316); see also *infra* notes 156-59 and accompanying text (discussing the consequences of ignoring the separate corporate entity doctrine).

86. Rev. Rul. 77-316, 1977-2 C.B. 53, 54-55.

87. *Id.* The analysis of Revenue Ruling 77-316 recognizes S1, S2, and S3, as independent corporate entities only to the extent that in view of their business activities, the economic reality of each corporate situation will differ. *Id.*

88. See, e.g., *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 426 (1948) (adhering to the decision in *Moline Properties* that a corporate entity must be the entity taxed, rather than its shareholders, when it engages in "business activities"); *Strick Corp. v. United States*, 714 F.2d 1194, 1203-1204 (3d Cir. 1983) (citing several cases that represent the separate corporate identity doctrine's "continuing validity" for federal income tax purposes); *Bennett Paper Corp. v. Commissioner*, 699 F.2d 450, 451-52 (8th Cir. 1983) (affirming the continuing importance of the separate corporate identity doctrine).



#### IV. JUDICIAL VIEW OF CAPTIVE INSURANCE COMPANIES

*Carnation Co. v. Commissioner* first analyzed risk shifting in captive insurance companies.<sup>89</sup> The United States Tax Court held that a parent corporation was not entitled to a section 162 business expense deduction to the extent the captive insured the parent's risks.<sup>90</sup> One year later the United States Court of Appeals for the Ninth Circuit affirmed.<sup>91</sup>

In 1971, Carnation incorporated Three Flowers, a wholly-owned captive insurance company in Bermuda.<sup>92</sup> Initially capitalized with \$120,000.00, Three Flowers promptly reinsured Carnation's and its subsidiaries' various risks.<sup>93</sup> Following Three Flowers' creation, Carnation purchased a blanket insurance policy from American Home.<sup>94</sup> Three Flowers later reinsured 90 percent of American Home's liability under Carnation's policy.<sup>95</sup> The reinsurance arrangement required American Home to pay Carnation's claims and subsequently seek reimbursement from Three Flowers.<sup>96</sup>

American Home expressed concern about Three Flowers' ability to cover American Home's losses prior to entering into the reinsurance arrangement.<sup>97</sup> Although refusing to issue American Home a letter of credit to secure Three Flowers' financial status, Carnation agreed to capitalize Three Flowers with an additional \$3,000,000.00.<sup>98</sup>

The Internal Revenue Service determined that Carnation could not

89. See *Carnation Co. v. Commissioner*, 71 T.C. 400, 401 (1977), *aff'd*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981) (determining whether amounts paid to an unrelated insurance company as insurance premiums and thereafter reinsured by Carnation's wholly owned Bermuda insurance subsidiary are deductible as ordinary and necessary business expenses).

90. *Id.* at 405.

91. See *Carnation Co. v. Commissioner*, 640 F.2d 1010, 1013 (9th Cir.), (upholding the tax court decision but offering a different analysis in reaching that result) *cert. denied*, 454 U.S. 965 (1981).

92. *Id.* at 402. See generally TAX MGMT. (BNA) No. 433, at A-9 to A-11 (1983) (describing a typical captive off-shore insurance arrangement).

93. *Carnation Co. v. Commissioner*, 71 T.C. 400 (1977), *aff'd*, 640 F.2d 1010, 1013 (9th Cir.) (upholding the Tax Court decision), *cert. denied*, 454 U.S. 965 (1981).

94. *Id.* at 402. American Home was a domestic insurance company that provided insurance coverage for Carnation commencing September 22, 1971. *Id.* The insurance coverage provided by American Home is referred to as a blanket insurance policy that covers losses arising from fire, lightning, vandalism, malicious mischief, sprinkler leakage, flood, and earthquake shock. *Id.*

95. *Id.* at 403.

96. *Id.* Of the \$1,195,000.00 paid from Carnation's annual premiums to American Home, \$1,755,000.00 were later transferred to Three Flowers. *Id.* at 404.

97. *Id.*

98. *Id.*

deduct the reinsurance cost as a business expense paid to Three Flowers.<sup>99</sup> The Internal Revenue Service advanced four arguments to support disallowing Carnation its business deduction.<sup>100</sup> The tax court, however, based its decision on risk shifting, the first of the four arguments.<sup>101</sup> The tax court found that the agreements between Three Flowers, American Home, and Carnation embodied no risk shifting<sup>102</sup> because Carnation would ultimately bear 99 percent of the risk of its anticipated losses.<sup>103</sup> Further, since American Home insured Carnation only after Carnation agreed to further capitalize Three Flowers, the risk of loss shifted. Three Flowers reimbursed Carnation's insurance claim from the money Carnation used to capitalize Three Flowers. Therefore, Carnation's risk of loss did not pass to Three Flowers. Carnation's agreement to capitalize fully its captive, Three Flowers, neutralized any risk shift.<sup>104</sup>

Following *Carnation*, several court decisions used the economic family analysis to determine the presence of risk shifting in captive insurance company cases.<sup>105</sup> Two such cases, *Stearns-Roger Corp. v. United*

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99. *Id.* at 405.

100. *Id.* at 405-06. First, the Internal Revenue Service attempted to define risk shifting as an essential element of insurance. *Id.* The amount reinsured by the subsidiary represents no risk shift. *Id.* Second, the Internal Revenue Service contended that no deduction is allowed for amounts set aside as self-insurance. *Id.* Third, the Internal Revenue Service argued that the amount ultimately received by Three Flowers was not paid or incurred as defined by section 162, because the amounts paid remained within Carnation's practical control. *Id.* Fourth, the insurance contract represented no exchange of value because Carnation ultimately bore the risk. *Id.*

101. *Id.* at 411.

102. *Id.*

103. *Id.* at 403.

104. *Id.* at 405. Although finding no risk shifting, the Tax Court did not use the economic family analysis to come to its decision. Instead, the Tax Court focused on the interdependence of the insurance contract between Carnation and Three Flowers and Carnation's obligation to capitalize Three Flowers in order for Three Flowers to meet its insurer obligations. The Tax Court determined that these two agreements together neutralized any Carnation risk insured by Three Flowers. *Id.* at 410. Therefore, there was no risk shifting.

The Circuit Court similarly found no risk shifting from Carnation to Three Flowers. *Carnation Co. v. Commissioner*, 71 T.C. 400 (1977), *aff'd*, 640 F.2d 1010, 1013 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981). The Circuit Court, however, fully adopted the economic family analysis formulated in Revenue Ruling 77-316. *Id.* Instead, of focusing on the relationship between the parent corporation and the captive insurance company based on the interdependence of the insurance contract and capitalization agreement, the Circuit Court concluded that no risk shifted because the risk was retained by a wholly-owned subsidiary of the parent corporation. Therefore, the risk was not transferred to a business entity outside of the parent corporation's economic family. *Id.*

105. *Carnation Co. v. Commissioner*, 71 T.C. 400 (1977), *aff'd*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981); *Stearns-Roger Inc. v. Commissioner*, 577 F. Supp. 833 (D. Colo. 1984), *aff'd*, 774 F.2d 414 (10th Cir. 1985); *Crawford-Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Ohio 1985); *Clougherty Packing Co. v.*

*States* and *Crawford-Fitting Co. v. United States*, used the economic family analysis but produced different results. In *Stearns-Roger*, the court held that the parent corporation was not entitled to deduct insurance.<sup>106</sup> In *Crawford-Fitting* the court permitted such a deduction.<sup>107</sup> Emphasis on different factors produced these different results.

In *Stearns-Roger*,<sup>108</sup> the court focused on whether the captive insurance company should be treated as a corporate entity distinct from the parent corporation.<sup>109</sup> Although the court recognized that the two corporations were separate entities, the court believed the corporations were part of a single economic family because the captive insurance company was a wholly-owned subsidiary of the parent.<sup>110</sup> Since both corporations were in the same economic family, the mandatory risk shifting for insurance purposes was not present.<sup>111</sup> Therefore, premium payments made to such an insurance contract were not deductible as Section 162 business expenses.<sup>112</sup>

In *Crawford-Fitting*, the court required the insured corporation to shift the risk of loss to an insurer outside of the insured's economic

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Commissioner, 84 T.C. 948 (1985).

106. *Stearns-Roger Corp. v. United States*, 577 F. Supp. 833, 838 (D. Colo. 1984), *aff'd*, 774 F.2d 414 (10th Cir. 1985).

107. *Crawford-Fitting Co. v. United States*, 606 F. Supp. 136, 148 (N.D. Ohio 1985).

108. *Stearns-Roger Corp. v. United States*, 577 F. Supp. 833, 834 (D. Colo. 1984), *aff'd*, 774 F.2d 414 (10th Cir. 1985). *Stearns-Roger* found it expensive to maintain traditional insurance policies, so it incorporated the captive insurance company to provide less expensive coverage. *Id.* The captive insurance company was incorporated as a wholly-owned subsidiary of *Stearns-Roger* and capitalized by *Stearns-Roger* with \$1,000,000.00. *Id.* at 834-35.

The government first argued that there was no risk shifting because the premiums paid by *Stearns-Roger* to its captive insurance company were self-insurance reserves. *Id.* at 835. Additionally, such self-insurance premiums are not a deductible business expense because the risk remains with the insured establishing the reinvestments. *Id.* The government's second argument, which the court incorporated in its decision, stipulated that because the captive insurance company was a wholly owned subsidiary of *Stearns-Roger*, the premiums were simply a transfer of capital within the *Stearns-Roger* family. *Id.* Therefore, just by the relationship of the insured and insurer, no risk was shifted. *Id.*

109. *Id.* at 836. The court recognized that a corporate entity will not be disregarded if the corporation is formed for valid business purposes. *Id.* In addition, the court further stated that wholly-owned subsidiaries may be separate taxpayers from their parent corporation. *Id.* Nevertheless, the court went on to hold that because of the relationship between the captive insurance company and *Stearns-Roger*, no risk shifting can occur.

110. *Id.*

111. *Id.* at 838. The court concluded that the risk of loss remains within the parent corporation's economic family because when the captive insurance company is a wholly-owned subsidiary of the insured corporation, the insured corporation bears any loss suffered by the captive insurance company. *Id.*

112. *Id.*

family.<sup>113</sup> Unlike *Stearns-Roger*, the court found that the insured corporation shifted its risk of loss to its captive insurance company.<sup>114</sup> Therefore, the court did not treat two separately incorporated entities as a single economic family.<sup>115</sup>

The court in *Crawford-Fitting* used a four part analysis to determine that the insured corporation transferred the risk of loss.<sup>116</sup> First, the insured corporation did not completely own the captive insurance company.<sup>117</sup> Unlike the relationship between the insured corporation and the captive insurance company in *Stearns-Roger*, the captive insurance company in *Crawford-Fitting* was not a wholly-owned subsidiary of the insured corporation.<sup>118</sup> Second, the court found that the insured corporation incorporated the captive insurance company not for tax avoidance, but for legitimate business purposes.<sup>119</sup> Third, the premiums charged by the captive insurance company represented normal premiums and were proportionate to the risks they covered.<sup>120</sup> Finally, the

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113. *Crawford-Fitting Co. v. United States*, 606 F. Supp. 136, 148 (N.D. Ohio 1985).

114. *Id.* at 149.

115. *Id.*

116. *See supra* notes 61-72 and accompanying text (describing five elements of the economic family analysis that must be viewed before determining whether an insured corporation shifted the risk to its captive insurance company). The court in *Crawford-Fitting* employed these various elements to decide the case. *Crawford-Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Ohio 1985). This marked a departure from the economic family analysis applied in *Stearns-Roger*. In *Stearns-Roger*, the relationship between the captive insurance company, a wholly owned subsidiary of the insured corporation, and the insured corporation raised the presumption that the two corporations were within the same economic family. *Stearns-Roger Corp. v. United States*, 577 F. Supp. 833 (D. Colo. 1984), *aff'd*, 774 F.2d 414 (10th Cir. 1985).

117. *Crawford-Fitting Co. v. United States*, 606 F. Supp. 136, 138 (N.D. Ohio 1985). The insured corporation was not the parent corporation of the captive insurance company. *Id.* at 145. *Crawford-Fitting Company*, along with three other manufacturers, manufacture and sell various products to four warehouses. *Id.* Each one of these warehouses that distributes the manufactured goods are incorporated separately. *Id.* These warehouses owned 80% of the captive insurance company's stock while several directors of *Crawford-Fitting Company* owned the remaining 20%. *Id.* Although one person owns 100% of *Crawford-Fitting Company's* stock and various percentages of the warehouses' stock, the court found this fact inconsequential, noting that each corporation was independently incorporated pursuant to valid and legitimate business purposes. *Id.* at 146.

118. *See Crawford-Fitting Co. v. United States*, 606 F. Supp. 136, 146 (N.D. Ohio 1985) (finding that the ownership of the captive insurance company was diversified to the point that no one shareholder held more than a 20% ownership interest in the captive insurance company).

119. *Id.* at 147. The court and both parties agreed to the stipulation that the captive insurance company was incorporated so that *Crawford-Fitting Company* could secure insurance at more economical rates and without excessive restrictions on the types and amounts of risks insured. *Id.* at 138.

120. *Id.* at 147. After entering into an insurance relationship with its captive insurance company, *Crawford-Fitting Company* paid its premiums at the market rate. *Id.* at

captive insured risks independent from the insured corporation's.<sup>121</sup> For these reasons, the court determined that the risk of loss shifted from the insured corporation to the captive insurance company and the insurance premiums were valid business expenses.<sup>122</sup>

From the series of cases commencing with *Carnation*, it is clear that the courts used the economic family analysis to determine risk shifting. Application of this analysis to captive insurance companies, however, varies from case to case. In *Carnation*, the Tax Court focused on the interdependence of the insurance contract and the capitalization agreements.<sup>123</sup> On appeal, however, the Ninth Circuit affirmatively adopted the economic family analysis set forth in Revenue Ruling 77-316.<sup>124</sup> Similarly, *Stearns-Roger* applied the economic family analysis looking strictly at the relationship between the parent and captive insurance company.<sup>125</sup> In *Crawford-Fitting*, however, the court determined that the captive insurance company was not in the insured's economic family after analyzing the nature of the relationship between the two corporations and analyzing the financial and managerial independence of the captive insurance company.<sup>126</sup>

## V. CURRENT JUDICIAL POSTURE ON CAPTIVE OFFSHORE INSURANCE COMPANIES

### A. MOBIL OIL CORPORATION V. UNITED STATES

In this recent case Mobil Oil Corporation (Mobil) sought a refund of federal income taxes paid, together with interest, for the years 1961 through 1969.<sup>127</sup> During those years, the Internal Revenue Service disallowed deductions for insurance premium payments to Mobil's captive insurance companies.<sup>128</sup> In its decision, the United States Claims Court

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121. *Id.* at 147. The captive insurance company provided comprehensive general liability and product liability insurance for approximately 45 companies associated with Crawford-Fitting Company and 115 independent distributors, none of which are owned by Crawford-Fitting Company. *Id.* at 138.

122. *Id.* at 147-48.

123. *Carnation Co. v. Commissioner*, 71 T.C. 400, 405 (1977), *aff'd*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981).

124. *Carnation Co. v. Commissioner*, 71 T.C. 400 (1977), *aff'd*, 640 F.2d 1010, 1013 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981).

125. *Stearns-Roger Corp. v. United States*, 577 F. Supp. 833, 836-38 (D. Colo. 1984), *aff'd*, 774 F.2d 414 (10th Cir. 1985).

126. *See supra* notes 116-22 and accompanying text (describing the factors the court used in analyzing the nature of the captive insurance company in *Crawford-Fitting*).

127. *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 556 (1985).

128. *See id.* at 568 (concluding that Mobil was not entitled to a refund for disal-

held that Mobil failed to shift the risk of loss to its captive insurance company affiliates; a valid insurance agreement was not formed; and therefore, Mobil could not claim a business expense deduction for those payments.<sup>129</sup>

Prior to 1960 Mobil protected itself and its affiliates, such as Mobil Overseas,<sup>130</sup> from major property and casualty risks through self insurance.<sup>131</sup> Subsequently, questions arose within Mobil concerning the effectiveness of employing a self-insurance program for insuring Mobil's foreign affiliates.<sup>132</sup> These problems came to the attention of Mobil Oil in the "Adam's Report."<sup>133</sup> The suggestions set forth in the Adam's Report led directly to the incorporation of the General Overseas Insurance Company, Limited ("GOIC"), which eventually was replaced by Bluefield Insurance Limited ("Bluefield"); both wholly-owned insurance affiliates organized in the Bahamas and Bermuda<sup>134</sup> to insure certain risks of Mobil and its affiliates.<sup>135</sup> Mobil insured 100 percent of its

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lowed deductions of insurance premiums paid to Mobil's captive insurance companies).

129. See *id.* at 567 (stating that absent a shift in the risk of loss Mobil's use of a captive insurance company is an extension of Mobil's self-insurance policy).

130. See *id.* at 556-57 (providing Mobil Overseas with the power to offer financial aid and advice to all Mobil Oil's affiliates). In 1951 Mobil Overseas Oil Company, Inc. (Mobil Overseas) was organized as a wholly-owned domestic subsidiary of Mobil Oil to coordinate the overseas activities at Mobil's affiliates. *Id.*

131. *Id.*

132. *Id.* at 557-58. Such questions concerned the adequacy of protection present in self-insurance programs, the cost efficiency of employing a self-insurance program, and the ability to centralize more effectively Mobil Oil's insurance coverage. *Id.*

133. *Id.* The Adam's Report concluded that the methods of Mobil Overseas and its affiliates of insuring their risks should be revised. The Mobil Overseas policy of self-insurance was not being followed by its affiliates because of their inability to generate sufficient self-insurance reserves. The report recommended that an insurance affiliate be formed to provide insurance for Mobil Overseas affiliates. *Id.*; Plaintiff's Post-Trial Brief at 7, Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985).

The report recognized advantages to switching to the use of a captive insurance company. One such benefit was the cost savings in regards to tax savings and retaining the profit of the insurance transaction within the group. Mobil Oil Corp. v. United States, 8 Cl. Ct. 555, 557-58 (1985); Defendant's Brief at 8, Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985). In anticipation of these savings, the board of directors of Mobil Overseas and its affiliates approved the report. Mobil Oil Corp. v. United States, 8 Cl. Ct. 555, 558 (1985).

134. *Id.* at 558-59. GOIC and Bluefield were separate corporations whose employees and offices were located in the Bahamas and Bermuda. *Id.* Each corporation was managed according to standard insurance practices while writing both direct insurance and reinsurance of United States and foreign risks. *Id.* at 559.

135. Mobil Oil Corp. v. United States, 8 Cl. Ct. 555, 558-59 (1985). GOIC was organized as a wholly-owned subsidiary of Mobil Holdings, Ltd., a Bahamian corporation wholly-owned by Mobil Overseas. *Id.* Eventually, Mobil Holdings became a direct subsidiary of Mobil Oil. *Id.* GOIC remained a subsidiary of Mobil Holdings until political instability forced the liquidation of GOIC. *Id.* At the beginning of 1968, Bluefield commenced writing insurance and reinsurance previously written by GOIC. *Id.* at 559.

Bluefield was incorporated in Bermuda as a subsidiary of Holdings S.A., a Luxem-

catastrophe risk through these companies.<sup>136</sup> Additionally, Mobil Overseas affiliates obtained loans with funds accumulated by GOIC and Bluefield.<sup>137</sup> Therefore, GOIC and Bluefield provided Mobil Oil with a more efficient insurance program and an added source of funds for reinvestment.<sup>138</sup>

The majority of Mobil Overseas affiliates either insured their risks directly with GOIC or Bluefield or with an independent insurance company that in turn reinsured with GOIC or Bluefield.<sup>139</sup> Thereafter, a corporate policy developed obligating GOIC and Bluefield to reinsure policies between a primary insurer and Mobil or an affiliate.<sup>140</sup> GOIC and Bluefield normally did not reinsure the risks of parties other than Mobil or its affiliates unless the risks bore some relationship to the business activities of Mobil and its affiliates.<sup>141</sup>

In *Mobil Oil* the Claims Court examined whether Mobil sufficiently transferred its risk of loss to GOIC and Bluefield so as to create a valid insurance agreement.<sup>142</sup> Applying the prior case analysis that decided the deductibility of insurance premiums paid to captive insurance companies,<sup>143</sup> the Claims Court held insufficient risk existed to constitute insurance, and therefore, the premiums were not deductible as an ordinary and necessary business expense.<sup>144</sup> The Claims Court focused on the interdependence of the insurance contracts and Mobil's contractual obligation to capitalize the captive insurance company.<sup>145</sup>

In concluding that Mobil did not sufficiently shift the risk of loss, the Claims Court employed the economic family analysis.<sup>146</sup> The court stated that Mobil should finance any losses GOIC or Bluefield suffered,

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bourg corporation. *Id.* Bluefield maintained its offices in Hamilton, Bermuda and remained a subsidiary of Mobil Oil Holdings through 1969. *Id.* Mobil Oil indirectly owned all of the stock of Mobil Oil Holdings. *Id.*

136. *Id.* This was never possible in the past because of the high risk industries in which Mobil Oil was engaged. *See supra* note 32 (discussing high risk industries).

137. *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 559-60 (1985).

138. *Id.* at 567.

139. *Id.* at 562.

140. *Id.* at 563. In 1960, Mobil Oil began insuring its United States risks with AIRCO, an unrelated domestic insurance company, which almost entirely reinsured with GOIC. *Id.* The AIRCO representative who negotiated the agreement testified that he did not fully investigate GOIC's financial status because of its status with Mobil Oil. *Id.* Therefore, AIRCO never requested a letter of credit from Mobil Oil. *Id.* at 561. Bluefield entered into a similar agreement with AIRCO upon GOIC's liquidation. *Id.* at 560-62.

141. *Id.* at 561.

142. *Id.* at 563.

143. *Id.*

144. *Id.* at 568.

145. *Id.* at 567.

146. *Id.*

and that Mobil should benefit from any profits realized by the affiliates, and that Mobil's financial statements should reflect any gain or loss.<sup>147</sup> In addition, other Mobil Oil affiliates could receive a percentage of the profits and insurance reserves held by GOIC and Bluefield as funds for investment and credit purposes.<sup>148</sup> The Claims Court concluded Mobil did not shift the risk to its insurance affiliates because the premiums paid by Mobil remained within the same economic family and the funds used to reimburse casualty losses would originate from within the same economic family.

### B. MOBIL OIL ANALYSIS

*Mobil Oil* reaffirmed the economic family analysis determining whether an indemnification agreement with a parent's captive insurance company successfully transfers the risk of loss required by *Le Gierse*.<sup>149</sup> Mere reliance on the economic family analysis, however, is an insufficient method to evaluate captive insurance companies because it: (1) ignores the separate corporate entity doctrine; (2) disregards the valid business purposes for establishing captive insurance companies; and (3) focuses on the wrong evidentiary materials.<sup>150</sup> Alternatively,

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147. *Id.*

148. *Id.*

149. See *supra* notes 56-72 and 89-126 and accompanying text (discussing the inception of the economic family analysis in Revenue Ruling 77-316 and its judicial use in cases involving captive insurance companies commencing with *Carnation Co. v. Commissioner*). During its analysis of the deductibility of insurance premiums paid to captive insurance companies, the Claims Court discussed the holdings in many cases to determine what sufficiently shifts the risk of loss to constitute insurance for federal income tax purposes. *Carnation Co. v. Commissioner*, 71 T.C. 400 (1977), *aff'd*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981); *Stearns-Roger Corp., Inc. v. United States*, 577 F. Supp. 833 (D. Colo. 1984), *aff'd*, 774 F.2d 414 (10th Cir. 1985); *Crawford-Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Ohio 1985); *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985).

150. The Claims Court adopted the economic family analysis applied in *Carnation* and *Stearns-Roger*. This application looks solely at some parent corporation-subsidary link. See *supra* notes 123-26 and accompanying text (describing the two forms of economic family analysis). *Mobil Oil*, however, is more similar to *Crawford-Fitting*. In *Mobil Oil*, the captive insurance company was not a subsidiary of Mobil Oil. Instead, Mobil Oil's captive insurance companies were subsidiaries of Mobil Oil Holdings, a Luxembourg corporation. Mobil Oil only indirectly owned its captive insurance companies. *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 558-60 (1985). Furthermore, GOIC and Bluefield insured risks of many corporations affiliated with Mobil Oil that were separate corporations and not wholly-owned by Mobil Oil. *Id.* Therefore, the economic family analysis of *Crawford-Fitting* that analyzes the nature of the captive insurance company is a more appropriate economic family analysis for this case. See *supra* notes 123-26 and accompanying text (describing benefits of this second type of analysis).

Although the *Crawford-Fitting* form of economic analysis is more applicable than the *Stearns-Roger* form, use of Section 482 to analyze the deductibility of insurance



Section 482 of the Tax Code offers a more effective means than the economic family analysis for evaluating Mobil's business deduction for insurance premiums paid to its captive insurance company.<sup>151</sup>

### 1. *Mobil Oil Ignored the Corporate Entity Doctrine*

In *Mobil Oil* the Claims Court stated that if it disregards the separate corporate entities, the court is simply reclassifying the transaction.<sup>152</sup> No further cases attempt to reconcile the corporate entity doctrine with the economic family analysis.

Further, the facts of *Mobil Oil*, as compared to *Carnation*, sufficiently differ to justify arguing against the use of the economic family analysis. GOIC and Bluefield separated themselves further from Mobil's identity than Three Flowers separated itself from Carnation's identity in *Carnation*. In contrast with the Three Flowers and Carnation arrangements, Mobil's insurance affiliates used independent management, operated an international insurance business insuring all Mobil subsidiaries, and engaged in a high business volume.<sup>153</sup> These factors illustrate Mobil Oil's intent to maintain a corporate identity separate from GOIC and Bluefield.<sup>154</sup> Therefore, the economic family analysis created a "family" where no "family" was intended.<sup>155</sup>

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premiums is more effective because it offers the Internal Revenue Service more freedom to consider all aspects of a transaction. *See infra* notes 161-71 and accompanying text (setting forth the benefits of a Section 482 analysis).

151. *See* Plaintiff's Post-Trial Brief at 39-40, *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555 (1985) (suggesting that the Internal Revenue Service should use Section 482 in this case to determine if the transaction in question meets an arm's length standard rather than focusing on a Revenue Ruling 77-316 economic family approach); *but see* Defendant's Brief at 94-99, *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555 (1985) (arguing that Section 482 is not the proper means to decide this case because the sole issue is whether or not the captive insurance arrangement is insurance).

152. *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 567 (1985). The court dispensed with the separate entity doctrine by stating that insurance premiums paid to captive insurance companies do not totally disregard the separate nature of corporate entities. *Id.* In effect, however, the court is reclassifying a transaction including two separate corporations as one involving solely one corporation. *Id.* In the Claims Court opinion, Section 482 was never mentioned or discussed as an alternative basis to decide *Mobil Oil*. *Id.*

153. *See id.* at 558-60 (discussing the hierarchy of Mobil Oil subsidiaries and their respective responsibilities); *see also supra* notes 92-98 (describing the lack of autonomy of Carnation's captive insurance company in *Carnation Co. v. Commissioner*).

154. *Id.* The decision in *Mobil Oil* failed to discuss the relevance, if any, of the intent of the taxpayer in incorporating a captive insurance company and deducting the insurance premiums paid to the captive insurance company. *Id.*

155. In *Clougherty Packing Co. v. Commissioner* 84 T.C. 948 (1985), the Tax Court held that insurance premiums paid to the petitioner's wholly-owned captive insurance subsidiary are not deductible by the petitioner as an ordinary and necessary business expense. *Id.* at 955. Although the tax court stated that it did not employ the

## 2. Mobil Oil Disregarded Valid Business Purposes

*Mobil Oil* also disregarded the valid business purposes embodied in a captive insurance company.<sup>156</sup> The Adam's Report recommended the creation of a captive insurance company to monitor effectively the risks of Mobil and its affiliates.<sup>157</sup> Nonrecognition of these valid business reasons creates the unavoidable inference that the sole acquisitional purpose of the insurance affiliates is avoidance of federal income taxes. Premiums paid to a captive insurance company, therefore, are not deductible once it is found that the insured and insurer are in the same economic family.<sup>158</sup> Unfortunately, this inference conflicts with the notion that tax benefits often co-exist with the many valid business purposes of insuring through a captive.<sup>159</sup>

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economic family analysis in its decision, the opinion still appears to apply an economic family approach. *Id.* The Tax Court found that the risk of loss did not shift from the petitioner to the captive insurance company because the corporations were two related parties. *Id.* at 954. This finding assumes that the risk of loss cannot shift between two related corporate entities, i.e. a parent and subsidiary. This theory, however, is essentially the economic family analysis.

The dissent in *Clougherty* cited the majority's failure to appreciate the corporate entity doctrine. *Id.* at 958. The dissent viewed the majority opinion as a form of the economic family theory. *Id.* Instead of creating a strict economic family rule which would "automatically preclude insurance between related entities," the dissent wanted to create a more flexible rule that would analyze a captive insurance company as more than an economic family member. Such a flexible rule would not disregard the separate corporate entity doctrine in the eyes of the dissent. Furthermore, the dissent argued that application of the economic family rationale will cause confusion in captive insurance cases with unique sets of facts. *Id.* Therefore, the dissent argued for a new theory to test the deductibility of insurance premiums paid to a captive insurance company.

156. See *supra* notes 28-35 and accompanying text (describing business purposes for establishing a captive insurance company).

157. *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 562-63 (1985). The following reasons compelled Mobil Oil to organize a captive insurance company:

1. eliminating expensive or inadequate local insurance coverage of Mobil Overseas affiliates and providing coverage for major risks which were not adequately protected;
2. providing a means whereby Mobil Overseas affiliates could pool their premiums and thereby obtain protection against loss;
3. pooling the mass purchasing power of Mobil Overseas affiliates in an insurance affiliate which would be able to obtain broad catastrophe coverage at low cost;
4. creating a centralized insurance program which would broaden, simplify and coordinate the insurance coverage of Mobil Overseas affiliates while at the same time reducing their premium costs; and
5. avoiding the administrative costs normally reflected in commercial insurance premiums to make money in the insurance business.

*Id.*

158. See *supra* notes 54-60 and accompanying text (discussing the economic family analysis).

159. See *Alinco Life Ins. Co. v. United States*, 373 F.2d 336, 341-45 (Cl. Ct. 1967) (observing that the presence of tax benefits in a particular business transaction

### 3. *Mobil Oil Focused on the Wrong Evidentiary Factors*

The final weakness in the decision in *Mobil Oil* is the excessive reliance of the court on the capitalization agreement between Mobil and GOIC. A parent normally incorporates a subsidiary with adequate capitalization to commence that subsidiary's business.<sup>160</sup> Capitalization agreements usually accomplish this task. Because the purpose of the agreements is to detail the relationship between a parent and subsidiary, inevitably the two bodies do not appear separate within the corpus of the agreement, despite being separate corporate entities.

The weakness of the decision in *Mobil Oil* points to the need for a different analysis to determine whether a valid transfer of risk occurred: one that looks beyond the formal parent-subsidiary relationship to the existence of valid business purposes. Section 482 of the Internal Revenue Code involves this more equitable analysis.<sup>161</sup> To clearly reflect an organizations' income, section 482 grants the Commissioner of the Internal Revenue Service discretionary power to allocate gross income, deductions, credits, or allowances among organizations within an economic network.<sup>162</sup> Pursuant to section 482, if two or more business organizations are owned directly or indirectly by the same interests, the Commissioner may distribute the deductions claimed by the parent corporation.<sup>163</sup> This is true even in the absence of tax avoidance motives.<sup>164</sup> This distribution, exercised in the Commissioner's discretion, is

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does not constitute tax avoidance).

160. See H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* 356 (1983) (stating that a parent corporation will adequately capitalize its subsidiary to treat the two corporations as separate corporations in order for the parent corporation to limit its liability as the sole shareholder of its subsidiary).

161. See B. BITTKER & J. EUSTICE, *supra* note 73, at 15-15 (describing section 482 as a primary means for the Internal Revenue Service to police the propriety of transactions between parents and affiliated corporations).

162. I.R.C. § 482 (West 1986). Section 482 provides that:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasions of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

*Id.*

163. *Id.*

164. See Rev. Proc. 70-8, 1970-1 C.B. 434, 434 (advising the Internal Revenue Service to consider the effects of a particular transaction between two members of a group of controlled entities for purposes of applying section 482); see also Treas. Reg. 1.482-1(c) (authorizing the Internal Revenue Service to analyze the tax avoidance motives of a particular transaction).

necessary to prevent tax avoidance.<sup>165</sup>

Use of section 482 would impose on the parent corporation a rebuttable presumption that the captive insurance company was created for tax avoidance purposes.<sup>166</sup> To rebut this presumption, the parent must prove the captive is a separate taxable entity.<sup>167</sup> The parent corporation would also receive the opportunity to demonstrate the captive was not established for tax avoidance purposes by offering valid business purposes for insuring through the captive.<sup>168</sup>

Furthermore, analysis under section 482 permits courts greater flexibility in approaching this problem. The economic family analysis limits a court's view of a captive insurance arrangement. If a captive insurance company is within a parent corporation's economic family, then insurance premiums paid to the captive insurance company are not deductible by the parent corporation.<sup>169</sup> The presence of valid business motives or the intent to operate the captive insurance company as a separate business entity are not given adequate consideration in judicial opinions.<sup>170</sup>

Under section 482, judicial analysis of captive insurance companies is broader and focuses on the separate corporate identity doctrine. The taxpayer bears the burden to demonstrate that both it and the captive insurance company exist independently and that valid business reasons

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165. *See Oil Base Inc. v. Commissioner*, 362 F.2d 212, 214 (9th Cir. 1966), *cert. denied*, 385 U.S. 928 (1967) (disallowing deductions for commissions paid by a parent corporation to a wholly-owned foreign subsidiary under section 482 because the commissions were twice the amount paid to unrelated parties for similar services).

166. *See Rev. Proc. 70-8, 1970-1 C.B. 434, 435* (placing the burden of proof on the taxpayer to justify a deduction being examined by the Internal Revenue Service through section 482).

167. *See Plaintiff's Post-Trial Brief at 23-30, Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555 (1985) (arguing that the captive insurance company is a separate taxable entity thus attempting to defeat an Internal Revenue Service attack on Mobil Oil's captive insurance company).

168. *See Rev. Proc. 70-8, 1970-1 C.B. 434, 434* (requiring the taxpayer to demonstrate existence of a proper business arrangement); *see also* Treas. Reg. 1.482-1(c) (stating that an Internal Revenue Service district director has the authority to perform the following: determine if a business transaction is a sham transaction designed to reduce or avoid taxes by distorting income; and determine whether two taxpayers are dealing at arm's length and are not attempting to use the same tax deduction or credit twice). Proper organization of the captive will accomplish the arm's length separation. Specifically, proper organization includes creation of the captive for valid business purposes; maintenance of separate offices, records, and decision-making officers; some retention of assets; and, effective transferral of risk. Provided these elements can be shown by the parent, the presumption of tax avoidance may be lifted. *Id.*

169. *See supra* notes 61-72 and accompanying text (discussing the application of the economic family approach to captive insurance companies).

170. *See B. BITTKER & J. EUSTICE, supra* note 73, at 15-6 - 15-9 (discussing arm's length analysis).

caused the parent to form the captive insurance company.<sup>171</sup> Assuming the parent corporation meets this burden, it may deduct insurance premiums paid to a captive insurance company. This approach allows a court to review a captive insurance agreement with a wider scope and escape the strict rule of the economic family analysis.

## VI. CONCLUSION

The numerous business purposes of captive insurance companies guarantee their use in the years to come.<sup>172</sup> The deductibility of insurance premiums paid to a captive insurance companies, however, does not face as secure a future.

The Internal Revenue Service and the courts, through the economic family analysis, disallow insurance premium deductions when the premium is paid from a parent corporation to a subsidiary captive insurance company. This analysis, however, possesses several flaws. It ignores the separate corporate entity doctrine and the valid business reasons for creating a captive insurance company. Therefore, an alternative approach toward captive insurance companies could more effectively evaluate the deductibility of premiums paid to them.

Such an alternative approach is section 482. This section allows the Internal Revenue Service greater discretion to view all factors associated with a captive insurance company rather than solely its relationship to its parent corporation. If such a new approach is employed, insurance premiums made to a captive insurance company may become deductible.

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171. 5 STAND. FED. TAX REP. (CCH) ¶ 2993.01 (1985).

172. *Crawford-Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Ohio 1985); Rev. Rul. 78-338, 1978-2, C.B. 107. In *Crawford-Fitting Co.*, the district court held that the amounts paid to a captive insurance as insurance premiums may be deductible as business expenses under section 162. *Id.* The district court allowed the deduction paid to the captive because the captive was: established for valid business purposes; a separate and independent corporate entity; and, also because the insured corporation was not the parent. *Crawford-Fitting Co. v. United States*, 606 F. Supp. 136, 147 (N.D. Ohio 1985).

Revenue Ruling 78-338, which distinguished Revenue Ruling 77-316, allowed the premium payment to a captive insurance company owned by 31 shareholders where no single shareholder held a controlling interest. Rev. Rul. 78-338, 1978-2 C.B. 107. In Revenue Ruling 78-338 a domestic corporation with foreign subsidiaries establishes a captive offshore insurance company. *Id.* The captive is owned by 31 unrelated parties and the captive only provides insurance for those 31 shareholders. The IRS ruled that payments to such a captive are deductible under section 162. *Id.* at 108.