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TAX AVOIDANCE AND THE DEFINITION OF INSURANCE: THE CONTINUING EXAMINATION OF CAPTIVE INSURANCE COMPANIES

Donald Arthur Winslow*

Both courts and commentators have disagreed on the ability of a corporation to take expense deductions for property and casualty insurance premiums paid to their captive insurance subsidiaries. This Article explains that the dispute over captives has been obscured in the debates. Both sides have framed their arguments around the technical presence or absence of insurance. Instead, the resolution of the dispute requires a choice between competing tax doctrines — economic reality and separate corporate entities. This choice is based upon a decision as to what arrangements constitute impermissible tax avoidance, not upon a strained and often inaccurate definition of insurance.

HEATED DEBATES SELDOM occur in cases concerning the income tax treatment accorded large business corporations. Nevertheless, tax lawyers will argue passionately over issues that test their notions of the tax system's basic structure. A bitter split of the Tax Court judges over such an issue has proved that point. This disagreement has surfaced in a line of cases concerning corporations' asserted expense deductions for property and casualty

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1. References to I.R.C. sections are to the current version of the Internal Revenue Code of 1986 unless otherwise specified. The year in parentheses is the year of the most recent publication of the United States Code, not the most recent version of the Internal Revenue Code. References to Treasury regulations are to the regulations currently in force, unless otherwise specified.
insurance premiums paid to their captive insurance subsidiaries.\(^2\) The issue of the propriety of these deductions has split the commentators as well.\(^3\)

In a typical captive insurance arrangement, a parent or other affiliate purchases insurance from an insurance corporation that is wholly owned by it or by a member of its corporate family.\(^4\) The insured generally claims a current deduction for the insurance premium as a business expense,\(^5\) and the captive insurer, while including the premiums in gross income, claims the benefit of special deductions afforded insurance companies under subchapter L of the Internal Revenue Code.\(^6\) Historically, subchapter L deduc-

\(^2\) The diversity of authority cited in the opinions by the Tax Court judges matches the strength of feeling on either side of the issue, with one judge drawing an analogy from an old television program, Clougherty Packing Co. v. Commissioner, 84 T.C. 948, 964 (1985) (Jacobs, J., concurring), aff'd, 811 F.2d 1297 (9th Cir. 1987), and another turning to Thomas Jefferson and the Declaration of Independence. Humana Inc. v. Commissioner, 88 T.C. 197, 224 (1987) (Körner, J., concurring and dissenting in part), aff'd in part and rev'd in part, 881 F.2d 247 (6th Cir. 1989). The matter appears to have reached a head in the recent Tax Court decision of Gulf Oil Corp. v. Commissioner, 89 T.C. 1010 (1987), with five separate opinions indicating a deep dispute over the issue.

\(^3\) Captive insurance subsidiaries will be referred to as the "captive" or "captives" throughout this Article.

\(^4\) Compare O'Brien & Tung, Captive Off-Shore Insurance Corporations, 31 INST. ON FED. TAX'N 665 (1973) (premium payments deductible only if captive has capacity to make losses good, more likely when captive insures other affiliates); Barker, Federal Income Taxation and Captive Insurance, 6 VA. TAX REV. 267 (1986) (premiums to captives deductible only to extent that captive is owned by other interests) and Taylor, Taxing Captive Insurance: A New Solution for an Old Problem, 42 TAX LAW. 859 (1989) [hereinafter Taylor, Taxing Captive] (captive arrangement should be attacked from the side of the insurer) with Knight & Knight, Disregarding the Separate Corporate Entity of Captive Insurance Companies: A Violation of the Moline Properties Doctrine? 1988 J. CORP. L. 399 (the premium deduction should be allowed in keeping with the Moline Properties doctrine); Bradley & Winslow, Self-Insurance Plans and Captive Insurance Companies—A Perspective on Recent Tax Developments, 4 AM. J. TAX POL'Y 217 (1985) (so long as captive not a sham, premiums may be deductible) and Sachs, Principles for Taxing Foreign Captive Insurance Companies, 1 AM. J. TAX POL'Y 45 (1982) (as long as captive is financially capable of carrying risks insured, there is no compelling reason to deny the premium deduction).

\(^5\) See Goshay, Captive Insurance Companies, in RISK MANAGEMENT 84 (H.W. Snider ed. 1964). The parent company may insure with its subsidiary, or a more complicated arrangement may be used. For example, a parent may own several operating subsidiaries and an insurance subsidiary that insures the other members of the corporate family. If the parent is primarily a holding company, the insurance subsidiary or captive would do the bulk of its insurance business with its brother and sister corporations, and not with the parent corporation.


\(^1\) See I.R.C. §§ 801-846 (Supp. V 1987). For example under I.R.C. § 832(b)(5), (c)(4) (Supp. V. 1987), insurance companies can deduct currently amounts that will be paid in the future with respect to "losses incurred" in the current period. Treas. Reg. §
tions have resulted in the insurer realizing little or no taxable income. Currently, they provide the insurer with favorable tax treatment not allowed to taxpayers generally. As a result, a corporate group utilizing a captive arrangement has been able to decrease substantially its taxable income without making a payment outside the corporate group.

The courts, in response to challenges by the Internal Revenue Service (the "Service" or "IRS") to the insureds' deductions of the premium expenses, have almost uniformly rejected the taxpayers' position with respect to these arrangements. This rejection, which has drawn some support from scholarly works, has been premised essentially on the ground that the transactions between affiliated corporations do not rise to the level of insurance for tax purposes. The perceived flaw has been a failure to effect the requisite risk transfer or risk shifting outside of the affiliated or economically related group.

The courts have reached these conclusions despite the vigorous objections of a number of dissenting judges as well as several commentators. The opposition has argued that in denying an insurance characterization because of the affiliation of the corporations the courts have improperly ignored the separate corporate existence of the contracting entities, a legal fiction that is gener-

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8. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), aff'd 84 T.C. 948 (1985); Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1986); Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985); Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981), aff'd 71 T.C. 400 (1978); Humana Inc. v. Commissioner, 88 T.C. 197 (1987), aff'd in part and rev'd in part, 881 F.2d 247 (6th Cir. 1989) (affirming the applicability of the risk shifting and risk distribution standard to captive arrangements, but holding that brother-sister corporations may meet that standard); Gulf Oil Corp. v. Commissioner, 89 T.C. 1010 (1987); Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985). But cf. Crawford Fitting Co. v. United States, 606 F. Supp. 136 (N.D. Ohio 1985) (captive with multiple owners respected).

9. See, e.g., Bradley & Winslow, supra note 3; Liles, Captive Insurance Companies: Further Confusion over Economic Families?, 26 TAX MGMT. (BNA) No. 17, at 226 (August 19, 1985); Sachs, supra note 3; Tinsley, Why Revenue Ruling 77-316 Is Wrong: A Captivating Argument, 9 J. CORP. TAX'N. 142 (1982); FORDHAM Note, supra note 6. See also O'Brien & Tung, supra note 3 (because captive insurance companies fill a need not met by existing insurance companies, their transactions should be accepted as insurance for tax purposes).
ally respected by the tax law.

The debate has grown louder recently because of two startling breaks from the developing case law which had favored the government's position. In the late 1987 decision of *Gulf Oil Corp. v. Commissioner*, 10 a majority of the Tax Court judges indicated in dicta that they would allow premium deductions by the insureds' in some captive arrangements. The instability of the developing doctrine was further illustrated by the Sixth Circuit's decision in *Humana Inc. v. Commissioner*, 11 in which the propriety of some premium expense deductions were upheld but by reasoning significantly different from that used by the *Gulf Oil* majority.

These developments show the need to reexamine the basic captive insurance company issue. In light of the strong and persistent disagreements over this issue and the emergence of some degree of conflict in the judicial decisions, the nature of the conflict in the captive cases should be reassessed, including its root causes. Each side recognizes only its own position and has difficulty perceiving any merit in the opposition's. The government and some courts have failed to give a satisfactory reason for denying the asserted tax treatment for captives, or even acknowledge that the cases raise a potential conflict with the general respect accorded separate corporate entities. Similarly, the opposition has clung steadfastly to a technical definition of insurance in order to support its own conclusions. Still, there are difficulties even with the distinctions, based on definitional approaches, suggested in *Gulf Oil* and *Humana* to permit the premium expense deductions in some cases.

The definition of insurance has also gained attention outside the captive context. As the industry market for insurance has moved away from the simple model of a small insured covering its risks with a large, unrelated insurance company for a fixed pre-

10. 89 T.C. 1010 (1987) (writing of unrelated insurance business can result in characterization of parent's arrangements with captive as insurance).

11. 881 F.2d 247 (6th Cir. 1989), *aff'd in part and rev'd in part*, 88 T.C. 197 (1987). The Sixth Circuit "ruled that while parent corporations cannot deduct premiums they pay directly to their wholly owned insurance companies, their subsidiaries are entitled to tax deductions paid to the captives." Adler, [*Captive Premiums Deductible: Court Ruling is First Major Victory For Captive Insurers*, Bus. Ins., August 7, 1989, at 1, col. 2 [hereinafter Adler, captive Premiums]] (Sixth Circuit's decision in *Humana* may open floodgates on captive issue due to deliberate restructuring of captive arrangements as a result of the court's holding). *See also* Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987) (finding of insurance for tax purposes must focus on whether risk of loss has been actually shifting by parent corporation), *aff'd* 84 T.C. 948 (1985).
mium, there has been significant focus on the definition of insurance to see how it relates to modern arrangements. These arrangements include captives as well as alternatives to conventional insurance arrangements, such as self-insurance or absence of insurance coverage. All may produce tax issues similar to those faced in the captive context and substantial matters such as the deduction of asserted premiums and treatment as an insurance company under subchapter L often hinge upon the definition of insurance. Furthermore, even when insurance is said to consist of risk shifting and risk distribution, the meaning of and distinction between these basic elements has not been clearly articulated by the tax authorities.

In order to accomplish the goals of rethinking the captive dispute and developing some principles by which to define insurance in anticipation of disputes in other insurance contexts, this Article will focus on the captive insurance cases. It will outline the current circumstances that make desirable a definition of insurance for tax purposes and then review the ambiguities in the tax authorities defining insurance. In light of this background, the Article will then examine the nature of the dispute in the captive cases.

This reexamination will show that the dispute over captives has often been obscured by the debaters. Both sides present their arguments as if the captive issue concerned only the technical presence or absence of the insurance element of risk shifting. The courts, the parties, and the commentators have failed to focus on the underlying issue: a conflict between tax doctrines — economic reality and separate corporate entities. This conflict intersects in an unusual fashion in the captive context, providing the potential for an extraordinary reduction of taxes. At stake is the loca-

13. See infra text and accompanying notes 21-52.
14. See infra text and accompanying notes 53-82.
15. See infra text and accompanying notes 86-137.
16. See, e.g., Knetsch v. United States, 364 U.S. 361 (1960) (transaction deemed a sham when the tax deduction was the only substantive thing realized); Gregory v. Helvering, 293 U.S. 465 (1935) (deduction disallowed because the corporate reorganization's sole purpose was to reduce taxable income).
17. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 439 (1943) (As long as the purpose of a corporate entity "is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate corporate entity."
tion of the line dividing permissible tax minimization and imper-
missible tax avoidance. Because of the nature of the captive issue
and the status of insurance theory, the line must be drawn more
finely than is usual in anti-tax avoidance analysis if the taxpayer’s
position is to be challenged. This difficulty partially explains why
the conflict has long defied satisfactory resolution or even full
understanding.

This recognition prompts two conclusions. First, the captive
issue should not be resolved by a purported definition of insurance,
but by an expressly recognized choice between the tax doctrines in
question. This conclusion requires that the issue be resolved with
minimal assistance from outside sources, such as an economist’s
definition of insurance. Second, captive cases should yield few
principles on insurance and risk shifting that are applicable to
cases regarding other insurance products. This is because
problems present in the captive context are best dealt with by
other solutions, and not by manipulating the definition of insur-
ance. We should resolve this issue as a matter of tax law rather
than one of insurance theory. The tax authorities have provided
few clear answers by overemphasizing the technical definition of
insurance.

The Article will evaluate the possibility that an analysis fo-
cusing upon what arrangements constitute impermissible tax
avoidance could be used to distinguish between captive arrange-
ments. The possibility of distinguishing between different types of
captive arrangements was suggested in *Gulf Oil Corp. v. Commis-
sioner*,18 the Tax Court’s recent decision which contains the first
substantial indication from the judiciary that single parent cap-
tives may be respected under some circumstances.19 This Article
will explore the feasibility of several approaches to making such a
distinction.

Finally, the Article will examine risk distribution, an aspect
of insurance theory that has not been developed by the cases. This
exercise will reinforce the conclusion that the conflict over com-
peting tax doctrines is unavoidable because insurance theory can-
not dispose of the issue.20

United States, 606 F. Supp. 136 (N.D. Ohio 1985) (captive with multiple owners
respected).
20. *See infra* text and accompanying notes 142-96.
I. THE INCREASED PRESSURE ON THE DEFINITION OF INSURANCE

In recent years, increasing attention has been focused on the definition of insurance for purposes of federal income taxation. As a result, tension has arisen in a variety of contexts. Taxpayers have sought to have various arrangements for coverage of property and casualty risks classified as "insurance" in order to obtain a current tax deduction for the obligation to pay premiums. The resulting controversy raises the question of whether it is possible to resolve these cases by continuing the present course of attempting to define the elements of insurance. If the attempt at definition proves problematic, an alternative must be found.

A. The Issues Involved in Defining Insurance

The definitional issues arise in the context of the wide variety of "cash flow" programs now available to provide coverage of property and casualty risks. Captive insurance arrangements, constitute the most visible of these programs because of the large and growing number of litigated captive cases. However, cash flow programs also include other "loss sensitive" insurance arrangements, such as retrospectively rated insurance programs. In addition, this conflict in the insurance area extends to less widely used arrangements such as retroactive insurance which provides coverage for events that have already occurred. Issues getting full exposure in the captive cases resemble those that could likely be litigated in other cash flow programs.

At issue in the various cash flow programs is the general rule relating to self-insurance. Liabilities not covered by an insurance contract, such as a future liability arising from a tort claim, are said to be self-insured by the party at risk. Under an established line of cases, a self-insured party cannot accrue a current deduction for self-insured liabilities. Thus, in the absence of an obliga-

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21. See generally Bradley & Winslow, supra note 3 (discussing case law that defines self-insurance and captive insurance programs).
22. See infra text accompanying notes 30-34.
23. See infra text accompanying notes 35-36.
tion to make a premium payment to another party under an insurance arrangement, the taxpayer would not have a current deduction relating to the liabilities.

The inability to get a current deduction for self-insurance (i.e., the absence of insurance) set the stage for the insurance arrangements now in question. If a deduction for self-insured losses could be accelerated to take advantage of the time value of money, the taxpayer would receive the financial benefit associated with an earlier tax deduction. Given the desirability of a current deduction, the early defeats of self-insurers possibly gave rise to the proliferation of captive insurance companies. Retroactive and retrospectively rated insurance programs are designed to achieve the same goals and purport to offer many of the same benefits, making them additional alternatives to self-insurance.

Retroactively rated insurance attracts those considering self-insurance by its retrospectively adjustable premium mechanism. Premium rates are adjustable based on experience within


The effect of deferring income, prepaying an expense, or lending at below-market interest rates can be to avoid tax on the investment income to be derived from investment of the amount so deferred, prepaid, or loaned, or to shift the tax burden on such income to the other party to the transaction.

Halperin, The Time Value of Money 1984, 23 TAX NOTES 751, 751-52 (1984). A simple example is an interest-free loan. In such a case, "if the form of the transaction were respected (i.e., neither the payment nor the receipt of interest were imputed), an interest-free loan would enable the lender to avoid tax and would overtax the borrower if interest she would have paid would have been deductible." Halperin, Interest, supra, at 513.


the policy period, so that the insured does not have a completely fixed premium coverage. From the insured's perspective, the deductibility of the premium amounts for insurance as a business expense is a chief concern. In general, the insurer will also desire the arrangement to be considered insurance in order to support its treatment as an insurance company under subchapter L, sustaining its current deduction of “losses incurred” with respect to the policy. Although the terms of the retrospectively rated plans are subject to substantial variation, with a principal variant being the range of permitted premium adjustments, the financial goals are similar to those of the captive arrangements. The premium expense is structured to correspond to actual loss experience. In some cases, actual payment of the premium is deferred until payment of the losses by the insurer. Because of the variable premium mechanism, retrospectively rated plans present issues of risk shifting and risk distribution that are similar to issues present in the captive context.

Retroactive insurance is a less common device which also


31. See generally Steere Tank Lines Inc. v. United States, 577 F.2d 279 (5th Cir. 1978) (amount paid by corporate taxpayer to insurance company not a deductible business expense where company was obligated to pay amount equal to the losses incurred); Tech. Adv. Mem. 8637003 (May 23, 1986) (estimated premiums based on expected losses to be incurred by taxpayers are not deductible); Tech. Adv. Mem. 8638003 (June 11, 1986) (same).


33. See R. RIEGEL & J. MILLER, supra note 30, at 378-81.

34. A discussion of the full range of potential tax problems facing a taxpayer using such an arrangement is beyond the scope of this Article. The issues may generally be stated as: (1) whether an arrangement calling for a premium which will roughly equal losses plus loading charges, achieves sufficient risk shifting to be insurance, and (2) whether an arrangement where premium obligations are contingent upon occurrence of losses justifies a current accrual deduction, even if the arrangement constitutes insurance.
places at issue the elements of insurance. This arrangement may be used by a business seeking to cover uninsured losses resulting from a disaster. It may also involve coverage of "incurred but not reported losses" of a prior period. The most notable case of the first type of such coverage occurred when MGM purchased retro-active insurance after its hotel burned in 1980. This arrangement illustrated a discontinuity in the tax law: since MGM was contesting the amount of its liability arising from the fire, it could not currently deduct any expense arising from this known loss, even though its accountants would require MGM to take a significant charge against current income for book purposes. MGM thus sought to gain a current deduction for the premium expense, while the insurance company offset the premium income with a deduction for losses incurred.

Each of these three types of programs (captive, retrospective, and retroactive insurance) presents the issue of whether the arrangement constitutes insurance. The government has been unreceptive to taxpayers' arguments supporting a characterization of the arrangements as insurance. In addition, the Internal Revenue Service has indicated a willingness to challenge the deductibility of premiums arising from retrospectively rated arrangements on the basis that such an arrangement is not insurance. These challenges have occurred from the perspective of the insured. The Staff of the Joint Committee on Taxation also questioned the insurance status of retroactive insurance arrangements. During the hearings, which questioned retroactive arrangements, it was suggested that Congress undertake to define insurance for purposes of federal income taxation. A Congressional effort to define insurance might occur if taxpayers were to prevail in any significant controversy concerning the characterization of an arrangement as


38. See STAFF OF JOINT COMMITTEE ON TAXATION, 98TH CONG., 1ST SESS., TAXATION OF PROPERTY AND CASUALTY INSURANCE COMPANIES 12 (Comm. Print 1983) [hereinafter JOINT COMMITTEE PAMPHLET].

39. Id. at 10-13.
insurance.

B. The Significance of Insurance in Tax Law

In order to understand the conflict over purported insurance arrangements, it is necessary to explain what makes insurance a significant issue in tax law.

Of primary importance is the potential for tax reduction by taxpayers. This possibility results from a combination of the insured's assertion of a current deduction with respect to the premium paid to the captive, with the tax treatment conferred on property and casualty insurance companies by subchapter L. Before the subchapter L provisions were changed by the Tax Reform Act of 1986, an insurance company was permitted to offset premium income with an undiscounted estimate of losses to be paid in the future. This treatment did not take into account the time value of money, which is inherent in an insurance company's use of premium reserves, during the period between the collection of premiums and their ultimate disbursement to pay claims. As a result, insurers were willing to enter into "cash flow underwriting" schemes which produced an initial underwriting loss for tax purposes (thereby producing a tax benefit for the remainder of the corporate group), with the expectation that this "loss" would be offset by investment earnings (themselves often tax-free) in the period before claims are paid. The qualification of such underwriting plans as "insurance" — at least under traditional rules — was subject to question.

Although controversies are still pending under former provisions of subchapter L, recent changes to these provisions apply prospectively. The Tax Reform Act of 1986 required insurance companies to discount their current deduction for losses incurred in order to take into account the time value of money and limited the opportunity for tax-free investment. Thus, the benefits to insurers have now been trimmed, although insurance companies are still subject to special rules in subchapter L which can give

42. It has also been noted that the 1984 amendments to I.R.C. Section 267 required a captive insurer to include premium income in the same period as the insured claimed the premium expense deduction. Taylor, Captive Insurance, supra note 7, at 451.
insurance companies a tax advantage over non-insurance companies by allowing a current deduction in some amount.43

Other factors have also enhanced the importance of the insurance characterization. Taxpayers likely to utilize the insurance arrangements in question are often accrual-basis taxpayers. An accrual-basis taxpayer has historically been able to take a deduction for a liability once all events have occurred that determine the fact of liability and the amount can be determined with reasonable accuracy.44 Under a long established interpretation of the "all events" test, taxpayers could not take a current accrual deduction for self-insurance because an obligation to pay an insurance premium was necessary to establish a current deduction related to the liabilities.45 However, by the late 1970's and early 1980's, taxpayers were encouraged by an emerging line of cases that appeared to be breaking down the old rule disallowing the current deduction with respect to self-insurance.46 This temporarily took the pressure off the definition of insurance.

The pressure returned with the advent of the "economic performance" rules that were introduced with the Tax Reform Act of 1984. Contrary to the previously emerging trend, these rules ensure that self-insured taxpayers cannot take a current accrual deduction for estimates of liabilities to be paid in the future, even though the liability itself might be conceded and its amount estimated with reasonable accuracy. The deduction for such liabilities, often arising from a tort or worker's compensation claim, must now satisfy not only the two prongs of the old "all events" test, but also the "economic performance" rules requiring payment to the claimant.47 The obligation to pay insurance premiums

43. See I.R.C. § 832 (Supp. V 1987). Professor Taylor believes that the 1984 amendments to I.R.C. section 267 and the requirement of discounting reserves under I.R.C. Section 846 remove both the tax advantages for captive insurers and the potential for abuse. Taylor, Captive Insurance, supra note 7, at 451. See also Bradley & Winslow, supra note 3, at 254-57 (amendment of subchapter L to discount reserves would remove much of the potential for abuse in captive arrangements).
45. See, e.g., Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930), affg 13 B.T.A. 189 (1928).
46. The rule against the deduction for self-insurance reserves began to soften in the mid-1970's and early 1980's when courts permitted deductions for the accrual of untested, but unpaid, worker's compensation liabilities. See Kaiser Steel Corp. v. United States, 717 F.2d 1304 (9th Cir. 1983); Crescent Wharf & Warehouse Co. v. Commissioner, 518 F.2d 772 (9th Cir. 1975). For a detailed discussion of these cases and the economic performance rules, see Bradley & Winslow, supra note 3.
however, still gives rise to a current deduction because economic performance is deemed to occur ratably over the course of the policy period, further demonstrating the importance that the transaction be classified as one of insurance from the side of the insured.

The alternative minimum tax ("AMT") rules, which are part of the Tax Reform Act of 1986 are expected to create additional interest in the characterization of insurance arrangements. The AMT is based in part on the difference between tax and book income. Fifty percent of any excess of book income over alternative minimum taxable income constitutes a portion of the alternative minimum taxable income, and is taxed at a twenty percent rate to the extent it exceeds the regular tax liability. This tax may be applicable if a tax deduction is taken in years following the year in which the deduction was taken for book purposes, such that book income would exceed the relevant tax income figure.

For example, in the MGM situation described above, book income would be reduced in the year of the fire, even though in the absence of either insurance or an actual payment to a claimant, there would be no corresponding tax deduction. The tax deduction would arise in a later year when the claim was settled. Because there would be no charge against book income in that year, book income could well exceed taxable income, thereby creating a "preference" for AMT purposes. Although it is possible to get a tax credit when book income initially exceeds taxable in-

51. Accountants generally do not count the premium payment to an affiliated insurer as an expense. See ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5, ¶ 27 (Fin. Accounting Standards Bd. 1982). Instead, accountants treat as uninsured, risks covered by "insurance through a subsidiary or investee to the extent not reinsured with an independent insurer." Id. This is supported by the statement that: "The effects of transactions between a parent or other investor and a subsidiary or investee company shall be eliminated from an enterprise's financial statements." Id. (citation omitted). In some circumstances, a payment to an unrelated insurance company may not result in a recognized accounting deduction:

[T]o the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company.

Id. at ¶ 44.
come, there is no reason to believe that this transaction will later cause such an inversion and the credit mechanism does not work backwards to achieve this result. Thus, the new AMT provisions provide an incentive to an insured to secure the insurance expense deduction at the same time as the book expense is taken, especially if a major item is involved.

For these reasons, characterization as insurance for a number of arrangements has taken on an increased significance. The importance of the characterization extends beyond the captive insurance context to that of other arrangements such as retrospective and retroactive insurance. It would be desirable to develop some rules to determine the existence of insurance in these arrangements. The inquiry begins by reviewing the tax authorities relevant to an analysis of the purported insurance arrangements.

II. TAX AUTHORITIES CONSIDERING THE DEFINITION OF INSURANCE AND THE CAPTIVE INSURANCE COMPANY CASES

A commentator on insurance has said that it is nearly impossible to define insurance. It has also been argued that it is unnecessary to do so since the correct results can be achieved on a case by case basis. These general observations suggest that it will be difficult to extract anything of use on the captive insurance issue and other tax issues from the general definition of insurance. Moreover, the commentators imply that tax authorities, purporting to base their decisions on a definition of insurance, may be influenced by factors other than pure insurance theory or economics.

These observations can be confirmed by an examination of the authorities. The historical definitions of insurance that can be gleaned from the tax authorities in existence over a decade ago are of limited assistance. The courts and the parties have continued to struggle with the early definitions primarily in the context of captive cases.

53. See R. Keeton, Basic Text on Insurance Law 2 (1971). For an indication of the difficulty inherent in this process as shown by an exhaustive attempt to collect the divergent definitions that have been proposed for the concept of insurance, see H. Denenberg, What Constitutes Insurance Within the Meaning of the Law (1965) (unpublished Ph.D. thesis available from University Microfilms, Inc., Ann Arbor, Michigan) [hereinafter Denenberg Manuscript].
A. Tax Authorities Antedating the Captive Cases

The early tax authorities, starting with the Internal Revenue Code and the Treasury Regulations, provide nothing more than broad, and typically unhelpful, generalities when defining insurance. Neither “insurance” nor “insurance company” is specifically defined by the Code, despite the great importance of such terms in determining the tax consequences to insurance companies and insureds. The Treasury Regulations give only a somewhat circular definition of “insurance company.” The regulations state that a company will be an “insurance company” only if its “predominant business activity” is the writing of “insurance” contracts. Otherwise it will not be treated as an insurance company.

55. See Joint Committee Pamphlet, supra note 38, at 11.
56. The regulations state that:
   The term “insurance company” means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.
   Treas. Reg. § 1.801-3(a)(1) (1960). See also Treas. Reg. § 1.831-3(a) (1963) (defining the insurance companies to be taxed under § 831 as “only those companies which qualify . . . under . . . paragraph (b) of § 1.801-1 and which are subject to the tax imposed by § 831.”); Rev. Rul. 71-404, 1971-2 C.B. 260 (“[A] title guaranty corporation . . . whose primary and predominant business activity during the taxable year is . . . the issuance of title insurance policies on real property . . . is an insurance company as defined in section 1.801-3(a)(1) of the regulations taxable under section 831(a) of the Code.”).
57. For example, in Estate of Clarence L. Moyer, 32 T.C. 515 (1959), a stock exchange established and operated a “Gratuity Fund” that paid death benefits to heirs of members. Payments were made upon admission to membership and those amounts together with a portion of the profits from the exchange financed the Gratuity Fund. The Tax Court held the Fund to be a separate entity from the exchange for tax purposes, and concluded that the Fund was an insurance company because its only activity was providing death benefits to members of the exchange. Other courts have reached similar conclusions. See, e.g., Commissioner v. Treganowan, 183 F.2d 288 (2d Cir. 1950) (gratuity fund is insurance where termination of membership results in forfeiture of all rights to death benefits), cert. denied, 340 U.S. 833 (1950); Estate of William E. Edmonds, 16 T.C. 110 (1951) (payment from gratuity fund constitutes insurance due to presence of risk shifting). See also Haynes v. United States, 353 U.S. 81 (1957) (employer’s private program of health and accident coverage was “insurance”).
58. For example, in Inter-American Life Insurance Co. v. Commissioner, 56 T.C. 497 (1971), aff’d, 469 F.2d 697 (1972), and Cardinal Life Insurance Co. v. United States, 300 F. Supp. 387 (N.D. Tex. 1969), rev’d on other grounds, 425 F.2d 1328 (5th Cir. 1970), entities claiming to be life insurance companies were denied that status because they did not aggressively seek insurance business, they had no active sales staffs, and their investment incomes greatly exceeded their incomes from premiums earned.
The Treasury Regulations show that the concept of "insurance" activity is relevant to insureds and insurers in different ways. For the insurer, it means that the entity must be primarily engaged in the writing of insurance contracts to be an "insurance company." For insureds, it means that the particular contract in question must possess the characteristics of insurance in order for the expense to be deductible as a premium expense. The insured faces the issue with respect to the individual contract in question, while the insurer faces the question with respect to the aggregate of its contracts after the "insurance" content of each individual contract has been determined.

The elements of such "insurance" activity were broadly defined in the case law long ago. "Insurance" is generally thought to consist of risk shifting and risk distribution. The seminal tax case which expressed these requirements was *Helvering v. Le Gierse*.

Subsequent authorities have generally accepted these elements as determinative of the presence of insurance, but the predominant

59. Even if a payment is made for something other than insurance, it may still be deductible as a section 162 business expense, unless it falls within the ambit of section 263. The argument was made long ago in support of the deductions for premiums paid to captives, that the deduction should be allowed as an ordinary and necessary business expense whether or not it is for "insurance" so long as the amount is determinable with reasonable accuracy. Sachs, supra note 3, at 58-59. The captive cases have, however, denied the deductions upon a finding that the payments were not for insurance. See, e.g., Humana Inc. v. Commissioner, 88 T.C. 197, 207 (1987) (no premium deduction allowed unless risk shifting and risk distribution are present), aff'd in part and rev'd in part, 881 F.2d 247 (6th Cir. 1989); Clougherty Packing Co. v. Commissioner, 84 T.C. 948, 960 (1985), aff'd, 811 F.2d 1297 (9th Cir. 1987) (payments made to wholly owned captive insurance company not deductible where there is no accompanying shift of loss). The Tax Court in *Humana* held that "in disallowing the payments as insurance premiums, we reclassified them as nondeductible." *Humana Inc.*, 88 T.C. at 207. The Sixth Circuit Court of Appeals agreed with the Tax Court on this issue, holding that payments by Humana to its wholly owned subsidiary did not constitute premiums because the risk of loss remained solely with the parent corporation. *Humana Inc.*, 881 F.2d 247.

60. 312 U.S. 531 (1941).

61. Two authors once suggested that United States v. Consumer Life Insurance Co., 430 U.S. 725 (1977), stands for the proposition that risk shifting is not necessary for there to be "insurance" for federal income tax purposes. See Curley & Wawro, *To What Extent Does Deductibility of Insurance Premiums Depend Upon Risk-Shifting?*, 53 J. Tax’n. 116 (1980). *Consumer Life* has been described as a case "in which the Supreme Court found that, although there was no significant risk shifting, a transaction was valid reinsurance." *Joint Committee Pamphlet*, supra note 38, at 14. It is an open question as to whether the Supreme Court intended to endorse such a broad proposition. In any event, that assertion has been thoroughly undercut as a general interpretation of *Consumer Life*'s effect on the definition of insurance by the growing number of captive insurance company cases decided in the last eight years, as well as other Supreme Court authority on the meaning of insurance. See, e.g., *Stearns-Roger Corp. v. United States*, 774 F.2d 414, 416 (10th Cir.)
focus in such authorities has been on the risk shifting component.

In *Le Gierse*, an 80-year-old woman purchased both an annuity contract and a single premium life insurance contract from a commercial insurance company. The risks to the insurance company under the two contracts — longevity under the annuity contract and early death under the insurance contract — neutralized each other. Moreover, the contracts could not be purchased separately and the premiums were calculated so that the insurer had no risk of loss. The Supreme Court held that the “insurance” policy did not constitute “life insurance,” the proceeds of which at that time could have been received tax-free. According to the Court, the proceeds from the policy were subject to estate tax, since the insurer had assumed no risk other than an investment risk dependent upon the time of payment.

1985) (no insurance resulted from captive arrangement in *Stearns-Roger* and *Consumer Life* "does not lead to a different result").

One further point on *Consumer Life* merits note. This Article concludes that the captive cases should focus on tax avoidance reasoning rather than risk shifting analysis and the definition of insurance. In that regard, *Consumer Life* has been criticized as an illustration of "what seems to be an increasing tendency of the courts to refuse to inquire deeply into problems of statutory interpretation except when faced with a plainly tax motivated event." *Gunn, Tax Avoidance*, 76 Mich. L. Rev. 733, 757 (1978) [hereinafter Gunn, Tax Avoidance]. The majority's only answer to the assertion that the statute did not warrant this result was that "state regulation would prevent 'overreaching' and that the reinsurance agreements served a business purpose." *Id.* at 758. I do not suggest that *Consumer Life* was correct in allegedly ignoring a statutory requirement. But Professor Gunn's view appears to suggest that an enhanced scrutiny for risk shifting in the captive context is occasioned by a suspicion of tax avoidance. If that is the case, it is even more evident that the decisions should be grounded on tax avoidance principles rather than on a variable notion of risk shifting. Professor Gunn might suggest that a neutral definition of risk shifting should be used. This Article suggests that such a neutral definition would not allow the courts to challenge the taxpayer's position in all cases, and if such a broad challenge is intended, the courts should admit that they are using tax avoidance principles.


63. The Court stated that:

Considered together, the contracts wholly fail to spell out any element of insurance risk. It is true that the "insurance" contract looks like an insurance policy, contains all the usual provisions of one, and could have been assigned or surrendered without the annuity.

Certainly the mere presence of the customary provisions does not create risk, and the fact that the policy could have been assigned is immaterial since, no matter who held the policy and the annuity, the two contracts, relating to the life of the one to whom they were originally issued still counteracted each other.

Here the total consideration was prepaid and exceeded the face value of the "insurance" policy. The excess financed loading the other incidental charges. Any risk that the prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank;

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The courts have followed this analysis and found the absence of insurance where the company in question did not assume an underwriting or economic risk. In addition, the risk must be substantial. For example, the insured purporting to cover a body of risks must utilize a contract that shifts to the insurer a risk of loss greater than the insolvency of the insured. Thus, such cases can be summarized as supporting the principle that the risk of loss transferred must be one of possible economic loss, significant in relation to the purported coverage, and beyond the control of the insured.

Notwithstanding occasional elaboration on particular facts, the basic elements of the definition of insurance set forth in *Le Gierse* continue to be the cornerstone of insurance-definition analysis. Because the policy in that case was found not to constitute insurance even though it was issued by a fully regulated commercial insurer, it shows that the definition is one of substance, not form. *Le Gierse* does not provide a complete definition however, because the Court did not elaborate upon the concepts of risk shifting and risk distribution. Its decision turned upon the absence it was not an insurance risk.

Id. at 541-42. In the companion case of Estate of Keller, 312 U.S. 543, 545 (1941), the Court emphasized that a “risk” based upon the prevailing interest rates which does not profitably cover the obligated annuity is not a risk in the sense necessary to constitute insurance. See also Kess v. United States, 451 F.2d 1229 (6th Cir. 1971) (a combined life-annuity contract carries only investment, not insurance, risks); Old Colony Trust Co. v. Commissioner, 102 F.2d 380 (1st Cir. 1939) (contract representing an investment with a provision for a return of premiums does not present the essential requisite risk shifting of insurance); Rev. Rul. 77-129, 1977-1 C.B. 189 (interest credited to a deposit fund does not involve the risk shifting element of insurance and hence is not tax deductible); Rev. Rul. 75-255, 1975-2 C.B. 22 (annual payments to the beneficiary of a Life Annuity and Death Benefit contract do not involve the risk shifting of insurance); Rev. Rul. 65-57, 1965-1 C.B. 56 (life insurance contract which could not have been acquired except in combination with a life annuity contract does not manifest the risk shifting of insurance).

64. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190 (7th Cir. 1978) (guaranteeing the presence of criminally accused persons by a bail bond company was not an insurance risk), cert. denied, 439 U.S. 835 (1978); Cuesta Title Guaranty Co. v. Commissioner, 71 T.C. 278 (1978), aff'd mem., 639 F.2d 787 (9th Cir. 1981) (obligation to make payments with respect to taxpayer's own negligence is not an insurance risk, as it fails to establish that the insurer bears the risk of the insured's loss).

65. See Steere Tank Lines, Inc. v. United States, 577 F.2d 279 (5th Cir. 1978) (adjustable premium contract which purported to cover a body of risks generally, but which only shifted the risk of insolvency, is not insurance), cert. denied, 440 U.S. 946 (1979).

of risk shifting. The *Le Gierse* Court left the definition of risk distribution unclear. Moreover, it was not clear whether risk distribution is a condition that must be satisfied in order for a given contract to qualify as insurance.\(^67\)

The term risk distribution is difficult to define because most tax authorities deal with it in the same conclusory manner as the *Le Gierse* Court. In one revenue ruling, a taxpayer purchased contracts similar to those in *Le Gierse*, with the annuity premium being equal to the face value of the insurance contract.\(^68\) The Service held that the contracts were not "insurance" because "the insurance company has not undertaken to shift the risk of premature death from the insured and to distribute the risk among its policyholders. On the contrary, by requiring the purchase of a non-refund annuity contract the company has eliminated this risk."\(^69\) From this description, a risk may be understood to be shifted, if it is assumed by the insurer and the insured is relieved from the potential financial loss.\(^70\) This has been termed the "vertical approach" to risk transfer.\(^71\) The requirement that the insurer "distribute the risk among its policyholders" is not clear on the face of authorities, such as this revenue ruling, because two sufficient reasons are given for the absence of insurance and only one is fully developed. Despite these observations, a general definition of risk distribution can be stated.

In simple contexts such as those in *Le Gierse* and the revenue ruling, if there is risk distribution, the incidence of any given loss may fall on those other insureds not suffering a loss. This occurs through their payment of premiums and the fact that they suffered no covered loss. Under this view of the insurance function, distribution can be seen as a form of shifting, as those risks that

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67. See generally I. Pfeffer, *Insurance and Economic Theory* 19-23, 46-49, 53 (1956) (insurer may rely on pooling or other means to perform risk distribution); A. Willett, *The Economic Theory of Risk and Insurance* 72 (Columbia University Press 1901), reprinted, (S.S. Huebner, Foundation for Insurance Education 1951) ("Where there is accumulation for uncertain losses, or whenever there is a transfer of risk, there is one element of insurance; only where these are joined with the combination of risks in a group is the insurance complete."); O'Brien & Tung, supra note 3, at 677-78 (citing many writers on insurance theory who regard risk distribution as a necessary element of the definition of insurance).


69. Id.


71. Id.
have been "shifted" to the insurer or common fund "vertically" are in turn "distributed" in a "horizontal" manner among the other insureds. This is a fair characterization of how some of the early leading cases defining insurance, such as Commissioner v. Treganowan, describe the distribution process. It is sometimes said that this risk distribution concept focuses on the broad social aspect of insurance as spreading the cost of a loss throughout the members of a group.

However, it is not clear that this "shifting" to the other insureds is a required part of the insurance process or its sub-part, risk distribution. Other early tax authorities implicitly contradict the interpretation of risk distribution as a horizontal form of shifting, but without clearly establishing the bounds of any disagreement.

This implicit contradiction occurred in United States v. Weber Paper Co., a case decided by the Eighth Circuit Court of Appeals. In that case, a reciprocal or inter-insurance exchange for coverage of flood loss was held to operate as a legitimate insurer of flood risks. This result was reached even though all subscribers were located in the same flood plain, so that if one suffered a loss,

72. Cf. Bradley & Taten, supra note 70, at 297 (transfer and distribution of risks may be accomplished by pooling or distribution — termed the "horizontal approach" to insurance). A more complete discussion of this asserted "horizontal approach" follows. See infra notes 73-78 and accompanying text.

73. 183 F.2d 288, 291 (2d Cir. 1950) (involving a stock exchange gratuity fund similar to that in Moyer), cert. denied, 340 U.S. 853 (1950). In Treganowan, the court stated that: "this plan provides a distribution of the risk, for because of the plan the risk of premature death is borne by the 1373 other members of the exchange, rather than by the individual." 183 F.2d at 291. See also Ross v. Odom, 401 F.2d 464 (5th Cir. 1968) (Death benefits are considered insurance when risk distribution and risk insurance are present in a binding arrangement. "This involves the payment of premiums . . . by a number of individuals into a common fund" out of which the benefit is paid.); Pickering v. Alyea-Nichols Co., 21 F.2d 501, 508 (7th Cir. 1927) ("[T]he basis of all insurance . . . is to distribute among the many the burden of losses accruing to the few.").


76. In Weber Paper, a subscriber paid a designated premium each year, and as the premium payments increased, the amount of coverage for each subscriber increased. As a result the exchange's reserves had to equal the face amount of insurance in force. The risks were not reinsured. In addition, the balance in the subscriber's account, in this case 99 percent, could be withdrawn upon 60 days notice effective after the end of a policy year. In the event of loss, all subscribers' accounts would be charged on a pro rata basis. Id. at 201-04.
all would probably suffer a similar loss, rendering payment on account of such losses a simple return of subscribers' premiums. Such a possibility should call into question the presence of risk shifting and risk distribution. The Service had earlier challenged such an arrangement essentially on that basis in Revenue Ruling 60-275. The District Court in Weber Paper expressly rejected the Commissioner's "no risk shifting" argument by emphasizing the transfer of the premiums to a separate entity where the taxpayer could not withdraw them at will, and stated that risk shifting was not negated by the probable occurrence of one major event affecting all insureds. Consequently, the amounts paid by the subscribers were held to be currently deductible as premiums. In fact, theoretical risk shifting and risk distribution were present by the arrangements with numerous insureds, but the other facts in the Weber Paper case relating to the undercapitalization of the exchange and the non-independence of the covered risks belie the existence of these insurance elements.

The failure of subsequent cases to clarify the principles used

77. Even though the distributions were to be "pro rata" from the funds held by the exchange, the payment on account of major losses occurring at the same time would mean that each subscriber would get back funds equal to the premium paid. In light of these facts, the Service took the position that "the taxpayer . . . did not, as a practical matter, lose control of its premium deposits, and . . . it was using [the exchange] as convenient depository for a contingency reserve, instead of retaining the amount of the reserve in the subscriber's own bank account or on its books." Id. at 204. The Service therefore argued that there was no shifting of the risk of loss from the insured.


79. Weber Paper Co., 204 F. Supp. at 400. The court rejected the Service's arguments by stating that they were:

based on the erroneous or irrelevant assumptions that there could be no real sharing of the risks because the occurrence of a major flood "probably would affect all properties in a particular flood basin"; that each subscriber is substantially underinsured; and the non-sequitur that any proceeds received by the taxpayer in the event of flood damage would, therefore, in fact, be a return of the taxpayer's own money. Such conclusions are also inapplicable to the case at bar since they ignore the fact that the deposits pass from the control of the taxpayer, and that no portion thereof can be withdrawn by the taxpayer during the policy year in which they are paid.

Id.

80. After the Weber Paper decision, the Service issued a further ruling adhering to its original position. Rev. Rul. 64-72, 1964-1 C.B. pt. 1, 85. While the government has continued to assail the result in Weber Paper, the courts in subsequent cases have looked to it for guidance on the definitional issues concerning risk shifting and risk distribution. See, e.g., Stearns-Roger Corp. v. United States, 577 F. Supp. 833 (D. Colo. 1984), aff'd, 774 F.2d 414 (10th Cir. 1985).
in *Weber Paper* left the definitional issues confused.\(^{81}\) Although
the focus in *Weber Paper* was on risk shifting, which is under-
standable since the purported insurer did not have the financial
capacity to bear a risk other than by returning an amount approx-
imately equal to the amount paid as premiums,\(^ {82}\) the facts also
implicated the risk distribution concept. Later cases have ac-
knowledged that the court in *Weber Paper* found both shifting
and distribution present.\(^ {83}\) The presence of a number of insureds is
generally seen as aiding in the insurance characterization.\(^ {84}\) It is
not clear from the facts as described in *Weber Paper* exactly how
this factor should be considered to have some significance, since
the decision might be interpreted as holding that the probabilities
that the risks of a given insured will in fact be distributed (or
shifted in the horizontal aspect of insurance) to another insured is
not relevant.\(^ {85}\)

These observations illustrate the ambiguities in the early
cases and rulings that existed as the modern insurance products,
such as captives and retrospectively rated plans, gained popularity
and headed toward litigation over their insurance characteriza-
tion. The vague definition of insurance for tax purposes left the

\(^{81}\) Revenue Ruling 60-275 and *Weber Paper* are representative of authorities that
present issues very similar to those found in captive insurance cases. To a large extent, the
Service's position in the captive insurance area grew out of 60-275. *See* Greene, *Tax
Problems*, supra note 40, at 257.

\(^{82}\) As a general matter, the concept of insurance requires that the actuarial bases of
the program must be sound. *See* Ross v. Odom, 401 F.2d 464 (5th Cir. 1968) (private
death benefit plan for state employees was "insurance" where based upon sound actuarial
principles); Davis v. United States, 323 F. Supp. 858 (S.D.W. Va. 1971) (no "insurance"
when judges' retirement plan not actuarially sound). It seems that the exchange in *Weber
Paper* had the financial strength to pay the losses covered, but there was a relatively close
correlation between the premiums paid and the likely loss payments.

\(^{83}\) *See* Steere Tank Lines v. United States, 577 F.2d 279, 280 (5th Cir. 1978) (per
curiam), *cert. denied*, 440 U.S. 946 (1979). In *Steere Tank Lines* the Fifth Circuit noted
that "[i]n *Weber*, a subscriber's premium payment would be used to pay flood losses suf-
fered by other subscribers. Thus, there was an element of risk shifting to the insurer, which
in turn distributed that risk of loss among all subscribers." *Id.*

\(^{84}\) *See*, e.g., Stearns-Roger Corp. v. United States, 577 F. Supp. 833 (D. Colo.
1984). *See also* *Steere Tank Lines*, 577 F.2d at 280 (5th Cir. 1978) (per curiam) (no risk
distribution present where there was only one insured).

\(^{85}\) The distribution is sometimes said, as in *Steere Tank Lines* and *Stearns-Roger*,
to have taken place among the insureds. The Service found this theory inaccurate, unless
one accepted the view that in the event of a major loss, each insured got part of his own
contribution back and part of every other insured's contribution, although every insured
only would receive approximately what it contributed. Also, it was theoretically possible
that this major loss in the flood basin was not the only potential loss. *See* Rev. Rul. 60-275,
1960-2 C.B. 43.
tax law ill-equipped to deal with modern insurance products. While these early authorities are of modest assistance in establishing some basic principles in this area, they do not resolve the fundamental issues.

B. A Review of the Captive Insurance Company Authorities

The development of the tax authorities dealing with captive insurance companies further reveals the uncertainty in the tax law's view of insurance principles. The Service and the courts have struggled with the captive arrangement for over a decade.

The definitional issues present with a captive arrangement can be seen most clearly in the context of a basic example. With a single captive insuring only the risks of its parent, there is the basic question of whether the insured has accomplished a transfer of risks by contracting with an affiliate, and also whether other insureds are necessary for there to be risk distribution. The same issues are present in somewhat diluted form when the captive insures risks outside of its affiliated group or is owned in part by interests outside that group.86 For that reason, the development of authorities began with the more basic arrangement given in the example above, and a detailed examination should also start from that point.

1. Single-Parent Captive With No Unrelated Business

Just over a decade ago, the Service addressed these issues and

86. For a retrospectively rated plan, there is the similar question of whether risk shifting occurs despite the variation of the premium to correspond with losses paid plus loading charges. Also, there is an issue of whether risk distribution is absent, since the variation of the premium means that the insured in question is unlikely to leave any funds "in the pot" for the other insureds. For the insured, these are questions relating to whether its contract is one of insurance, thereby affecting its ability to claim a deduction. See generally Rev. Rul. 77-316, 1977-2 C.B. 53, 54 ("[W]hen there is no economic shift or distribution of the risk 'insured,' the contract is not one of insurance and the premiums therefor [sic] are not deductible under section 1.162-1(a) of the regulations."). To be an insurer entitled to the tax benefits of subchapter L, a company must be predominantly engaged in issuing contracts effecting insurance. See Treas. Reg. §§ 1.801-3(a)(1) (1960), 1.831-3(a) (1963). The current focus on the insureds and their individual contracts can logically be extended to an analysis of the aggregate activity of an insurer. If that extension is followed, there is the question of whether the elements of shifting and distribution must also be present when one studies the position of the insurer.

Because the various cash flow plans share many common issues, a study of the developing captive insurance cases sheds light not only on that area, but also on the definitions of property and casualty insurance for tax purposes.
found neither risk shifting nor risk distribution in a single parent captive arrangement where the captive insured only its corporate affiliates.\textsuperscript{87} Revenue Ruling 77-316,\textsuperscript{88} denied the deductibility of premium payments made to a wholly owned foreign captive insurance company by the parent corporation and its other subsidiaries.\textsuperscript{88} The general reasoning of the ruling was that the corporations participating in the arrangement "though separate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss."\textsuperscript{89} Examining the "economic reality" of the transactions in this manner, the Service concluded that the arrangement lacked risk shifting and risk distribution and was, therefore, not insurance. The Service purported not to disregard the separate corporations but merely to disregard the transaction between them.

For about a decade, the Service enjoyed virtually unbroken success in establishing this result in the courts.\textsuperscript{90} The early cases involved relatively weak arrangements, such as inadequately capitalized captives, which had insufficient funds to pay for the expected losses of the insureds and therefore could not effect a transfer of risk.\textsuperscript{91} In some of these cases the precise reason for the Service's victory was not clear. A narrow reason relating to the

\begin{itemize}
\item \textsuperscript{87} The history related in this Article begins with the position taken in the published rulings of the Service. For a detailed history of the early development of this position within the Service, as indicated by unpublished memoranda, see Bradley & Winslow, \textit{supra} note 3, at 234-38.
\item \textsuperscript{88} 1977-2 C.B. 53.
\item \textsuperscript{89} Some details of the ruling will not be fully discussed as they are not necessary for the present discussion. First, the ruling purported to deal only with foreign captives, but its reasoning has been held to apply equally to captives organized under the laws of a state. \textit{See}, e.g., Stearns-Roger Corp. v. United States, 577 F. Supp. 833 (D. Colo. 1984), \textit{aff'd}, 774 F.2d 414 (10th Cir. 1983). Second, the ruling considered examples of direct insurance with a captive and the use of reinsurance. Rev. Rul. 77-316, 1977-2 C.B. 53, 54. The cases have not given any significant weight to the different fact patterns when the risks purportedly lie with the captive.
\item \textsuperscript{90} Rev. Rul. 77-316, 1977-2 C.B. 53, 54 (emphasis added).
\item \textsuperscript{91} The one captive case in which the government did not prevail was Crawford Fitting Co. v. United States, 606 F. Supp. 136 (N.D. Ohio 1985), a case involving such an unusual fact pattern that it is of little use in analyzing the arrangements discussed as single parent captives. \textit{See} Bradley & Winslow, \textit{supra} note 3, at 240 n.79.
\end{itemize}
capitalization was stated in some opinions. Other opinions appeared to accept Revenue Ruling 77-316 at least implicitly.

In general, a predominant group of cases comes very close to adopting the Service’s position that affiliated corporations cannot shift risks among themselves because they are in the same “economic family.” In any event, these cases essentially use an economic reality or consolidated financial statement accounting analysis of the transaction to make their determination. Yet no opinion has explicitly endorsed the “economic family” theory of Revenue Ruling 77-316.

The recent opinion by the Ninth Circuit in Clougherty Packing Co. v. Commissioner improved on the articulation of the earlier revenue ruling’s position with a “net worth” approach. The court asserted that the parent of a captive has no change in net worth when it “insures” with a subsidiary because a loss paid by the subsidiary reduces the net worth of the parent through the decrease in value of its stock in the subsidiary, as if the parent paid the loss itself. From that observation, the court concluded that no risk was shifted and the arrangement was not insurance. Moreover, the court concluded that this analysis did not disregard

93. See, e.g., Carnation Co., 71 T.C. 400. The Tax Court’s decision in Carnation largely turned upon the financial inability of the captive to bear the risks covered, and the parent’s agreement to provide capital to the captive. Similar issues relating to capitalization agreements and inadequate capitalization of the captive were present but ignored by the courts in Stearns-Roger and Beech Aircraft.

94. Carnation Co., 640 F.2d 1010, 1013 (9th Cir. 1980) (agreeing with Tax Court that risk was neutralized by offsetting agreements and noting that one fact pattern in Revenue Ruling 77-316 is identical to Carnation while rejecting Carnation’s argument that this ruling fails to recognize the separate status of corporations); Stearns-Roger Corp. v. United States, 577 F. Supp. 833, 836-38 (D. Colo. 1984) (citing Ninth Circuit decision in Carnation, noting the Court’s heavy reliance on Revenue Ruling 77-316 and applying an “economic family” analysis); see also Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1302, 1307 (9th Cir. 1987) (Carnation “explicitly refers to the Ruling” and both the ruling and Carnation “reach the correct result”).


98. 811 F.2d 1297 (9th Cir. 1987).

99. This rationale has been called a variation of the economic family approach. Barker, supra note 3, at 284-86.
the separateness of the corporations since it looked merely to the parent's worth.\textsuperscript{100}

Some of the opinions in the captive cases go beyond the Service's position containing arguments with anti-tax avoidance overtones. References have been made to the "loophole" nature of the arrangement.\textsuperscript{101} Statements that tax law preferred substance over form,\textsuperscript{102} thus borrowing from general tax principles, have also been made.\textsuperscript{103} Yet these anti-tax avoidance arguments were not fully developed or explained.

A second group of cases, which are primarily from the Tax Court, rely on what appears to be a more \textit{ad hoc} approach, often disclaiming reliance upon the "economic family" concept.\textsuperscript{104} The Tax Court began in 1985, with \textit{Clougherty Packing Co. v. Commissioner},\textsuperscript{105} to develop this different approach. The court expressly rejected the economic family theory because of the court's belief that reducing a captive insurance transaction to economic reality would disregard the separateness of corporate entities generally required under the Supreme Court's decision in \textit{Moline Properties, Inc. v. Commissioner}.\textsuperscript{106} Nevertheless, the Tax Court

\textsuperscript{100} Clougherty Packing Co. v. United States, 811 F.2d 1297, 1305-07 (9th Cir. 1987), aff'd 84 T.C. 948 (1985).

\textsuperscript{101} Beech Aircraft Corp. v. United States, 84-2 U.S. Tax Cas. (CCH) ¶ 9803, 85,404 (D. Kan. 1984), aff'd, 797 F.2d 920 (10th Cir. 1986).

\textsuperscript{102} Beech Aircraft Corp., 797 F.2d at 922.

\textsuperscript{103} See generally Gregory v. Helvering, 293 U.S. 465, 469-470 (1935) (corporation technically qualified as reorganized but was held to not be truly reorganized under the intent of the statute); Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185, 1192 (5th Cir. 1970) (tax consequences must turn upon the economic substance of a transaction and not upon the time sequences or form of the transaction."), \textit{cert. denied}, 401 U.S. 939 (1971); Barnett v. Commissioner, 364 F.2d 742 (2d Cir. 1966) (deduction not allowed on transaction in which taxpayer could not have realized profit and "transaction had no purpose, utility or substance apart from the tax consequences"), \textit{cert. denied}, 385 U.S. 1005 (1967).

\textsuperscript{104} See Gulf Oil Corp. v. Commissioner, 89 T.C. 1010 (1987); Humana Inc. v. Commissioner, 88 T.C. 197 (1987), \textit{aff'd in part and rev'd in part}, 881 F.2d 247 (6th Cir. 1989); Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985); Clougherty Packing Co. v. United States, 84 T.C. 948 (1985), \textit{aff'd}, 811 F.2d 1297 (9th Cir. 1987). The \textit{Mobil Oil} opinion also has overtones of form over substance and economic reality, but it ultimately turns to the language in the Tax Court's \textit{Clougherty Packing} decision, with the effect that the disallowance of the deduction is a recharacterization of the transaction. \textit{Mobil Oil}, 8 Cl. Ct. at 567.

\textsuperscript{105} 84 T.C. 948 (1985), \textit{aff'd}, 811 F.2d 1297 (9th Cir. 1987).

\textsuperscript{106} 319 U.S. 436 (1943). The \textit{Clougherty Packing} majority disclaimed reliance on the "economic family" concept because "it might foster a theory which would be extended to other areas of tax law," \textit{Clougherty Packing}, 84 T.C. at 959, and "such a concept cannot be reconciled with types of transactions between related entities other than insurance [transactions]." \textit{Id.} at 957. This meant that the "economic family" concept was per-
disallowed the taxpayer's deduction. The result was reached by a recharacterization process in which the court purported to consider all the facts and circumstances in determining whether the arrangements constituted insurance. The court reasoned that obligations would not constitute insurance premiums unless the contract transferred the risk from the taxpayer to another.\textsuperscript{107} The court concluded that the single parent captive did not accomplish that result. The premium payments were used only to pay the losses of affiliates and they were held to be the same as a nondeductible reserve for losses.\textsuperscript{108} The majority reached this result over a strong dissent arguing that the majority had in fact, if not in word, adopted the Service's economic family concept.\textsuperscript{109}

The Tax Court has subsequently adhered to and expanded upon this approach. In two subsequent cases, \textit{Humana Inc. v. Commissioner}\textsuperscript{110} and \textit{Gulf Oil Corp. v. Commissioner},\textsuperscript{111} the Tax Court has reaffirmed the recharacterization analysis without specifying any facts which are relevant to the recharacterization of the premium obligations as nondeductible items, other than the ownership of the captive.

The Tax Court's decision in \textit{Humana} is particularly notable for showing the flexibility of this approach with brother-sister corporations. The Tax Court in \textit{Humana} held that its analysis permitted a denial of a premium expense deduction by a subsidiary corporation that contracted for insurance with another subsidiary corporation of its (the insured's) corporate group. This fact pattern can be contrasted with the simpler situation where the parent insures with its subsidiary. It was this factual twist in \textit{Humana}, involving insurance between brother-sister corporations, that later convinced the Sixth Circuit to reverse that part of the Tax Court's decision which denied the deduction for premium expenses between brother-sister corporations because the net worth of those corporations could be affected by the purchase of insurance.\textsuperscript{112}

\begin{thebibliography}{112}
\bibitem{107} Clougherty Packing, 84 T.C. at 958.
\bibitem{108} Id.
\bibitem{109} Id. at 967-68.
\bibitem{111} 89 T.C. 1010 (1987).
\bibitem{112} The Sixth Circuit held that parent corporations cannot deduct premiums paid to wholly owned subsidiaries, but that the subsidiaries are entitled to tax deductions for premiums paid to the captive. The \textit{Humana} court stated that it was adopting the net worth
**Gulf Oil** involves the simpler parent-subsidiary situation in a case in which the court still denied the deduction. **Gulf Oil** is the first opinion in which a reader finds language that expresses an attitude not entirely hostile toward some captive variations while still containing overtones of substance over form. Speaking for the majority, Judge Whitaker opined that "'[a]lthough technically, transfer of risk may occur when a captive is involved that is a separate, viable entity, financially capable of meeting its obligations, we simply decline to recognize it as such when the arrangement is merely, in substance, the equivalent of a reserve for losses or self-insurance.'" Moreover, **Gulf Oil** is most significant for the dicta, discussed in the next section, further indicating a moderate approach, apparently acceptable to a Tax Court majority, with respect to captive cases that may be applicable beyond the single parent/single insured situation, such as the variations to which we now turn.

2. Single-Parent Captive With Unrelated Business

Authorities regarding the tax treatment of premiums to be paid to a captive that writes significant insurance coverage outside its affiliated group are just now beginning to develop. The presence of such outside business had long been thought by taxpayers and their counsel to possibly distinguish some captives from those in the litigated cases referred to above. In general, the view was that substantial unrelated business would increase the likelihood that the risk shifting aspect of the transaction would be respected. In the early analysis of the Ninth Circuit in *Clougherty Packing*, 881 F.2d at 252, which is discussed in the text accompanying notes 98-100. In doing so, the court stated that "'under no circumstances do we adopt the economic family argument advanced by the government.'" 881 F.2d at 257.

113. **Gulf Oil Corp.**, 89 T.C. at 1024.

114. See Bradley & Winslow, *supra* note 3, at 242-43. See also, Abramowitz & Allen, *supra* note 97, 328, 333 (arguing for a wider acceptance of **Gulf Oil**'s upholding of premium deductions when there are unrelated risks based on a definition of insurance); Adler, *Sears Sues to Retain Premium Deduction*, Bus. Ins., Mar. 13, 1989, at 2, col. 3 (Service uses economic family argument to challenge a captive arrangement where almost all of captive's businesses are unrelated).

115. For a detailed history of the development of an unpublished line of authority within the Service which suggested that the Service might respect the captive arrangement if the unrelated business was substantial (fifty percent of premiums or more), see Bradley & Winslow, *supra* note 3, at 237 n.69. The Service later repudiated this position as it
1980's, observers hoped that the issue would be addressed in *Mobil Oil Corp. v. United States*, a case then being tried in the Claims Court on several issues including one involving a captive insurance company which wrote approximately fifty percent of its business outside the affiliated group. The Claims Court denied the premium expense deductions based on the prior case law, with some reliance on the Tax Court's opinion in *Clougherty Packing*. The *Mobil Oil* opinion generally disappointed the observers by its failure to explain why the presence of unrelated business did not affect the outcome of the case. Because the facts recited in the opinion reveal an awareness of the unrelated business of the captive and the briefs in the case specifically address the issue, the Claims Court's opinion has been viewed as holding that unrelated business is irrelevant to the captive issue and does not aid the taxpayer in achieving risk shifting. The unrelated business issue appeared to be dying, if not dead.

Such a conclusion though, was apparently premature. In the Tax Court's previous captive opinions, the unrelated business issue was reserved, but few expected much to result from it after *Mobil Oil*. The court in *Gulf Oil Corp. v. Commissioner* dropped a bombshell when it announced in dicta that a significant amount of unrelated business would result in an insurance characterization of the transaction and a deduction for the premium expense. The court reasoned that such a situation could effect risk shifting because the premiums of the unrelated insureds might be used to pay the losses of the affiliated insureds. Under this view, the

conflicted with the government's position in *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555 (1985).

117. *Id.* at 562.
118. *Id.* at 566-68.
119. See Barker, supra note 3, at 310; Bradley & Winslow, supra note 3, at 243-44.
121. 89 T.C. 1010 (1987).
122. The *Gulf Oil* court stated that:

If all of the insureds are related, the insurance is merely self-insurance because the group's premium pool is used only to cover the group's losses. By adding unrelated insureds, the pool, from which losses are paid no longer, is made up of only the affiliated group's premiums. When a sufficient proportion of premiums paid by unrelated parties is added, the premiums of the affiliated group will no longer cover anticipated losses of all of the insureds; the members of the affiliated group must necessarily anticipate relying on the premiums of the unre-
risks would be shifted horizontally, through the presence of numerous insureds, rather than vertically, through a contract with a separate unrelated insurer. 123

The Service reacted swiftly to this novel approach to insurance theory. In Revenue Ruling 88-72, 124 the Service asserted its view that the parent's ownership of the captive prevents the existence of an insurance arrangement between the two entities, regardless of the underwriting by the captive of a substantial amount of unrelated business. Using a net worth analysis similar to that used by the Ninth Circuit in Clougherty Packing, the Service reasoned that the parent has not relieved itself of the risk since it will still bear the economic consequences of any loss through its ownership interest in the captive. 125

The unrelated business issue appears to be the new battleground concerning captives. The Service's denial of a premium expense deduction will be based on its use of the net worth theory. The net worth theory would deny an insurance characterization whether or not the captive insures unrelated risks, while providing a rationale that allows the Service to claim that it is looking at economic reality in such transactions and still respecting the separate corporate existence of both the parent and the subsidiary.

3. Captives With Multiple Owners and Insureds — The Group or Industry Captive

Throughout the controversy and debate over the types of captive arrangements discussed above, it has been assumed that a group or industry captive presented an arrangement justifying a deduction. A group captive is an insurance corporation organized

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123. The description of this view as "horizontal" risk shifting, and the contrast of it to the typical "vertical" risk shifting, was first made by Bradley & Taten, supra note 70, at 297.
125. Id. at 32-33.
to cover a number of parties operating in one particular industry, and is thus subjected to similar risks. Such a captive is owned by numerous corporations which then insure with it.

The published authority is generally favorable to taxpayers in this context. Over a decade ago, the Service issued Revenue Ruling 78-338, which found risk shifting and risk distribution, hence insurance, in such an arrangement involving thirty-one owner-insureds. One of the few cases decided in favor of the taxpayers, Crawford Fitting Co. v. United States, has been characterized as a group captive case. In Crawford Fitting, the captive was owned by the 100% shareholder of the insuring taxpayer, individuals who had business relationships with the taxpayer, and several corporations which were partially owned by the 100% shareholder of the taxpayer. The court found that this pattern of ownership meant that the captive and the taxpayer-insured were not so economically related that their financial transactions should be aggregated as in Revenue Ruling 77-316, in which the Service advanced its economic family theory, and the premium expenses were therefore held to be deductible.

The apparent acceptance by the authorities of group captives should not be interpreted as the final word on this issue. From the standpoint of economic reality, risk has not been shifted because the insured still owns a part of the insurer. This observation may lead the government to disallow a portion of such premium expense deductions "to the extent of the percentage ownership of the insurer by the insured." While this net worth analysis may be at odds with the Service's current guidance on the issue, Revenue Ruling 78-338, it is consistent with the direction that some of the cases have taken. Thus, at some point even the group cap-

128. See Barker, supra note 3, at 302-04. Another case, Beech Aircraft Corp. v. United States, 84-2 U.S. Tax Cas. (CCH) ¶ 9803 (D. Kan. 1984), aff'd, 797 F.2d 920 (10th Cir. 1986), involved an insignificant amount of outside ownership and the court did not treat it as a material fact.
131. Barker, supra note 3, at 306.
132. Id. at 307.
133. 1978-2 C.B. 107. See also Taylor, Captive Insurance, supra note 7, at 450 (The "IRS' literal net worth approach [requiring] each partial owner . . . experience a partial disallowance of its premium deduction . . . although dictated by the 'economic family' theory, is at odds with IRS' current position reflected in Revenue Ruling 78-338 and Revenue Ruling 80-120." (footnotes omitted)).
tive may come under attack by the Service.

4. Summary of Development of the Case Law

The Service has been remarkably successful in disallowing deductions for premiums to be paid to captive insurance companies. While no court expressly accepted the Service's "economic family" theory, they have shown no reluctance to use a net worth analysis or recharacterization approach in order to deny such deductions when a wholly owned captive with no unrelated business is involved.

The recent reversal of the Tax Court in *Humana* on the issue of premium expense deductions between sister corporations and captives and the Tax Court's dicta regarding the significance of unrelated business in its *Gulf Oil* opinion, indicates that the situation is not stable. As cases involving factual variations are entering the litigation process, dissenting voices to the wholesale disallowance of premium expense deductions are being heard. In addition, the government's argument has been refined to focus on the net worth variant of the economic family concept. The prior cases disallowing the deduction had rested on an absence of risk shifting, and typically eschewed an analysis of risk distribution as unnecessary to their decisions. The renewed debate similarly focuses on the risk shifting element.

With the issues now fully developed it is possible to subject the captive arrangements to more exacting scrutiny. In particular, it is possible to examine in greater detail the problems with resolving the captive issue based on a definition of insurance, especially one that depends on the existence of risk shifting.

III. The Captive Insurance Dilemma — Problems With Applying a Risk Shifting Analysis

For over a decade, the courts have faced one of the basic issues relating to captive insurance: the insured's ability to deduct


136. *See, e.g., Taylor, Captive Insurance, supra note 7, at 449* (Tax Court's approach is to find the absence of risk transfer and not answer the risk distribution question).
the premium expense.\textsuperscript{137} An uninitiated observer might wonder why the issue is still so troublesome after so much exposure. A principal reason is that the issues in conflict were not fully debated until the advent of the more recent decisions. With the impressive number of authorities mounting in opposition to the basic single parent captive arrangement, an observer could have concluded that the captive issue was decided. But those authorities consisted of cases with less challenging fact patterns and opinions authored by judges who perceived no merit in the taxpayers' position.

This situation first began to change as the Tax Court became more active in the captive cases. The recent decisions from that court, which still deny the deduction on the facts before them, contain factual variations of captive arrangements. These variations include coverage by the captive of the risks of unaffiliated corporations and brother-sister corporations, rather than simply the risks of the parent.\textsuperscript{138} The variations have caused a simmering dispute between the majority and a significant number of dissenting judges, to heat to the boiling point. This has resulted in swing vote judges producing a new majority on the Tax Court. This change has made possible the development of a different majority position on the issues, including the suggestion that not all deductions for premium expenses paid by an affiliate to a captive will be disallowed. This change is also present outside the Tax Court, as evidenced by the Sixth Circuit's reversal in \textit{Humana}, which resulted in the first major victory for the taxpayers in its allowance of a deduction for a premium expense paid to a brother-sister corporation.

This struggle to develop a coherent theory capable of respecting some captive arrangements has focused on the definition of insurance. In that process, the courts have grappled with some of the basic elements of insurance.

Another reason for the lengthy debate over the captive insurance issue is the failure of the opponents to join issue with each other. The strong words used by the Tax Court judges in their

\textsuperscript{137} The first case to address this issue was \textit{Carnation Co. v. Commissioner}, 71 T.C. 400 (1978), aff'd, 640 F.2d 1010 (9th Cir. 1981), \textit{cert. denied}, 454 U.S. 965 (1981). The courts have not faced the issue of the status of the insurer as an insurance company entitled to the tax benefits of subchapter L. This has been recommended as the means of attacking captives rather than by challenge of the insured's premium deduction. \textit{See Taylor, Captive Insurance, supra} note 7, at 452.

\textsuperscript{138} \textit{See Gulf Oil}, 89 T.C. 1010; \textit{Humana Inc.}, 88 T.C. 197.
bitter exchanges indicates that the basic captive issue cuts to core concepts in tax law. Judges upholding the government's characterization of the transaction have been criticized for failing to explain "how it is able to disregard the transactions in the [basic single parent captive] case without crashing head on into the holding of Moline Properties,"\(^\text{139}\) which is generally understood to permit affiliated corporations to deal with each other as separate legal entities. This criticism has been rebutted with the position that a captive arrangement in economic reality amounts to self-insurance, which does not produce a current deduction. In effect, the two sides are talking past each other. As a result, the opinions have pursued some questionable analyses that could have been avoided if both sides would characterize the issue as the tolerated level of tax avoidance, which is both the cause of the conflict and the subject of these cases.

A. Risk Shifting Analysis Produces a Difficult Conflict Between Competing Tax Doctrines

The roots of the conflict in risk shifting analysis lie in two competing lines of tax cases which deal broadly with uses and limits of anti-tax avoidance doctrines.\(^\text{140}\) The source of the conflict suggests that its resolution lies not with the definition of insurance, but with the policies behind general tax doctrines, such as protection of federal tax revenues,\(^\text{141}\) promotion of certainty in tax planning,\(^\text{142}\) and encouragement of legitimate business transactions.\(^\text{143}\) Because the conflict involves fundamental principles, it allows for no precise or uncontroversial resolution.

The two lines of cases essentially represent opposite conclusions reached in anti-tax avoidance cases. The first of these lines of cases is grounded in the general principle of substance over


140. Classification of doctrines in this area is itself somewhat problematic as the doctrines are interrelated. See generally Bittker, Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code, 21 How. L.J. 693 (1978) (discussing two lines of cases, one favoring substance, the other favoring form); Rice, Judicial Techniques in Combating Tax Avoidance, 51 Mich. L. Rev. 1021 (1953) (same).

141. The "justification for preventing tax avoidance is rational and legitimate: the need for protection of the federal revenues by preservation of public confidence in our system of taxation." Rice, supra note 140, at 1051.


143. See Rice, supra note 140, at 1023.
form. These cases stand for the proposition that economic reality governs when evaluating the effect of transactions; therefore transactions without a business or non-tax purpose will not be respected as to its form. Such cases include *Gregory v. Helvering*\(^{144}\) and *Knetsch v. United States*.\(^{145}\) The cases recognizing economic reality can be joined with those disallowing an accrual deduction for self-insurance, typified by cases such as *Spring Canyon Coal Co. v. Commissioner*,\(^{146}\) and perhaps supported by those disallowing the use of reserve accounting to estimate items of income to be received or paid in the future.\(^{147}\) The second line of cases has its roots in form, specifically the special recognition given to the corporate form under *Moline Properties, Inc. v. Commissioner*.\(^{148}\) *Moline* is understood to mean that separate corporate entities, including a parent corporation and its subsidiaries, are normally respected as separate entities.\(^{149}\)

The two lines of cases converge in the captive context. If economic reality controls, the captive arrangements are self-insurance. In contrast, if form prevails the transactions are insurance because they purport to be between two legally separate entities.\(^{150}\)

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144. 293 U.S. 465 (1935).
146. 13 B.T.A. 189 (1928), aff'd, 43 F.2d 78 (10th Cir. 1930), cert. denied, 284 U.S. 654 (1931).
147. *See generally* Schlude v. Commissioner, 372 U.S. 128 (1963) (cash received as advances for dance lessons to be rendered in a subsequent year is not tax deferrable); American Automobile Association v. United States, 367 U.S. 687 (1961) (Automobile Association's prepaid membership dues are not tax deferrable and must be included in the Association's gross income for the year in which the dues were received); Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957) (Commissioner did not abuse discretion in refusing to accept an accrual basis accounting method for repaying membership dues).
150. One commentator has stated that these two lines of cases were considered two of the more certain concepts among many vague tax avoidance doctrines. Rice, *supra* note 140, at 1052. Professor Rice stated that:

Without attempting an exhaustive assembly of the cases, it is clear that [predictable] principles include such major doctrines as those establishing that reallocation of income within a family group will not shift the incidence of income tax liability, nor will transactions which do not vary the actual command of income or the property taxed. Similarly, in reorganization cases the decisions require a continuity of interest, while profits are said to carry over in cases of merger and liquidation but deficits do not. In still another field, decisions respecting the circumstances under which a corporate entity will be disregarded have created a reasonably stable and dependable body of principles.
1. The Economic Reality Line of Cases

Examination of the conflict begins with the economic reality or substance over form cases. Considered under those cases, captives can be taken as an alternative form of risk management designed to obtain a current accrual deduction denied the self-insurers. It has been suggested that the use of captives grew from the early defeats of the self-insurers. In overall economic effect, captives circumvent Spring Canyon Coal, since the arrangement is essentially identical to self-insurance if the finances of all the affiliates are considered.

The tax law sanctions the use of economic reality to prevent tax avoidance if a transaction has no economic substance other than a tax deduction. Using this type of analysis, the Supreme Court in Knetsch v. United States disallowed a deduction for interest paid for the purchase of bonds, when the bonds yielded less than the interest on the loan to buy them. Knetsch is regarded as one of the leading cases in this economic reality line.

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Id. (footnotes omitted).


152. 364 U.S. 361 (1960).

153. This resembles the Court's analysis in Helvering v. Le Gierse, 312 U.S. 531 (1940) where the offsetting of aspects of a single transaction which neutralizes the economic effect of a part of the transaction were considered a means of tax avoidance. See supra text accompanying notes 60-63.

154. See Bittker, supra note 140, at 715-16. As related by Professor Bittker, this line of cases, derived from Gregory v. Helvering, 293 U.S. 465 (1935), was described by Learned Hand as follows:

The doctrine of Gregory v. Helvering . . . means that in construing [the] words of a tax statute which describe[s] commercial or industrial transaction[s] we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.

Bittker, supra note 140, at 715 (quoting Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), cert. denied, 338 U.S. 955 (1950)).

The Knetsch decision:

denied an interest deduction for loans of this type on the ground that the transaction itself was a sham, without explicitly employing the business purpose doctrine, but some decisions on identical transactions relied primarily on Gregory in reaching the same result, and these opinions were cited with apparent approval by the Supreme Court in Knetsch. Another formulation is that such a transaction lacks economic reality; in effect, it is all form and no substance.

Id. In Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967), the Second Circuit generalized the “business purpose” requirement to extend to personal activities when it denied the interest deduction “because the loan did not have ‘purpose, substance, or utility apart from [its] anticipated tax consequences.’” Bittker,
Cases in the economic reality line should be interpreted together with cases like Spring Canyon Coal, for the proposition that schemes which in substance constitute self-insurance will not give rise to a current deduction. Proponents of the economic reality line of cases would say that in substance, the affiliated group using a captive insurer is self-insured. The affiliated group is trying to use form to achieve by an indirect means that which it could not do directly.\textsuperscript{185}

2. The Form Over Substance Line of Cases

The substance over form analysis merely sets up the conflict with the other line of cases represented by Moline Properties.\textsuperscript{186} A natural extension of the principle of respecting the separate corporate form when there is a valid business purpose, is that separately incorporated entities can engage in transactions with affiliates as long as those transactions have a business purpose other than the avoidance of taxes.\textsuperscript{187} The purchase and sale of insurance is a nor-

\textsuperscript{supra} note 140, at 716. The court in defining its "purposive activity" requirement explained that the interest deduction would not be permitted:

[W]hen it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction: and a good example of such purposeless activity is the borrowing of funds at 4% in order to purchase property that returns less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential.

\textit{Goldstein}, 364 F.2d at 741-42.

155. For statements to this effect by courts considering captive cases, see, e.g., Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986); Stearns-Roger Corp. v. United States, 774 F.2d 414, 416-17 (10th Cir. 1985).


Bittker and Eustice state that:

In addition to possible application of the statutory provisions and principles . . . , transactions between affiliated corporations may fail to accomplish their tax expectations because of numerous other income, deduction, timing, and characterization rules . . . .

. . . .

It has long been the rule that transactions lacking in economic substance or reality will be disregarded for tax purposes. The fountainhead of this approach is, of course, the renowned case of \textit{Gregory v. Helvering}, but other equally well-
mal business transaction taking place between two separate parties. Because the terms of the contract can specify the shifting of risk, one cannot simply analyze the arrangement by its terms to be self-insurance without the transaction or one of the parties being disregarded. The carrying of insurance risks is a business that a subsidiary can conduct apart from its parent. Thus, in order to regard the liabilities assumed by a separately incorporated captive as self-insured, one must conclude that the liabilities stay with the insured affiliate corporation. This means that the location of the liabilities (under the contract) with the captive, is not respected in form. Thus, calling a captive insurance arrangement self-insurance on the grounds of economic reality conflicts with *Moline Properties.*

known applications can be found in the *Higgins, Griffiths, Knetsch* decisions. These general principles and attitudes, sounding in tax avoidance, business purpose, and form versus substance, have been applied in a number of cases involving sales of property between related corporations at a loss. 

[With respect to deductions claimed on a transaction between affiliates,] the fact that the parties are related, although not fatal, nevertheless imposes upon them a practical duty that they "turn square corners" in their dealings with each other, lest the transaction fail to satisfy [the] basic statutory requirements [such as those under Code section 162] and presuppositions of deductibility.


In contrast, Professor Gunn has stated that the "business-purpose doctrine is sensible to the extent that it means, as it seems to have meant in *Gregory,* that corporations must actually carry on business activities to be recognized as corporations under the reorganization provisions." Gunn, *Tax Avoidance,* supra note 61, at 738-39. This view of the business-purpose doctrine would apparently prevent it from imposing any nonstatutory requirements for commercial transactions, a more limited role than that normally assigned to it by scholars and courts, who "feel comfortable imposing a 'business purpose' requirement as an adjunct to almost any kind of transaction." Rosenberg, *Tax Avoidance and Income Measurement,* 87 Mich. L. Rev. 365, 396 & n.88 (1988).

158. Bittker and Eustice's description of the holdings in the captive cases illustrates how the authorities purport to avoid this conflict. They cite "the various captive insurance subsidiary cases, where separate entities are respected, but deduction is denied for purported premiums because arrangement is not insurance (no risk shifting or distribution, but only the economic equivalent of a self-insurance reserve)." B. Bittker & J. Eustice, *supra* note 157, at ¶ 15-37 n.102. This Article contests the non-insurance characterization if the separateness of the entities is indeed respected.
3. Traditional Tax Analysis: Failure of the Business Purpose Standard

Conflicts between form and substance in transactions between affiliated corporations have traditionally been resolved in a manner that does not overemphasize either alternative. Transactions between affiliates have been disregarded on occasion, but not by simply looking to the economic reality that all the affiliates are in the same corporate group. No transaction between affiliates would survive application of that standard. Traditional tax analysis could collapse an insurance transaction if one could conclude that the captive is a sham corporation with no business purpose and therefore its existence can be disregarded. Instead of automatically treating the captive as a sham with no valid business purpose, the transaction between the affiliated corporations might also lack a business purpose (i.e., non-tax reason) and can be disregarded under established principles of tax analysis.\(^{159}\)

The failure of the government or the courts to analyze captive arrangements under the business purpose standard\(^ {160}\) suggests

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159. The requirement of business purpose has long occupied a "valid and important role in [the] tax system." Surrey, *Definitional Problems in Capital Gains Taxation*, 69 Harv. L. Rev. 985, 995 (1956). See Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. Chi. L. Rev. 485 (1967) (role of motive in determining whether taxpayer had a valid business purpose). In addition, it has been observed that:

- it is hard to see how an Internal Revenue Code can be successfully applied in the modern world without the safeguards afforded by the Gregory doctrine and its various facets. It is a technique of statutory interpretation difficult to apply but essential to our tax system as it now operates.


160. An example of the failure to analyze captive arrangements under the business purpose doctrine is found in *Beech Aircraft Corp. v. United States*: "in matters of taxation, form must give way to substance . . . and the economic reality of the business arrangement rather than the outward form of a transaction will determine its tax consequences." 797 F.2d 920, 922 (10th Cir. 1986) (citing Gregory v. Helvering, 293 U.S. 465 (1935)). A statement that form prevails over substance is too broad and therefore devoid of analysis. Appeals to form or substance with lack of analysis seem to be, as Learned Hand stated, "vague alternatives . . . anodynes for the pains of reasoning." Commissioner v. Sansome, 60 F.2d 931, 933 (2d Cir. 1932).

The business purpose doctrine has also been criticized. See Summers, *supra* note 157, at 42; Business Purpose Note, *supra* note 157, at 1095. This Article however, is intended to show that the analysis of captive arrangements is driven to the use of the business purpose doctrine, and attempts to apply it in a principled and nonconclusory manner.

In discussing the application of the business purpose doctrine as a result of the decision in *Gregory*, the Supreme Court has taken a narrower approach than that urged by the government:
that the captive cases present an arrangement that the courts cannot handle under this analysis. It has been noted that the business purpose cases present "hard cases," and captive arrangements only magnify the degree of difficulty. This is because as applied to the captive arrangement, the business purpose test produces circular reasoning. In addition, once beyond the circularity problem, one may not be satisfied to reconcile the lines of cases represented by Knetsch and Moline Properties merely by asking whether there was a lack of business purpose. Instead, a more difficult choice

The Government urges that the principle underlying Gregory v. Helvering finds expression in the rule calling for a realistic approach to tax situations. As so broad and unchallenged a principle furnishes only a general direction, it is of little value in the solution of tax problems. If, on the other hand, the Gregory case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration.

Higgins v. Smith, 308 U.S. 473, 476 (1940). The taxpayer in Smith sold property to a corporation which he controlled merely to claim a tax loss. Disallowance based on Gregory should not be surprising in this case. The acquisition of insurance, however, can be undertaken to effect compliance with state laws or fulfill business obligations, such that it is difficult to say that the purchase of coverage from a regulated insurance company lacks business purpose because the insurer is a captive. Moreover, the broad "substance over form" statement is belied by numerous cases discussed infra which give regard to transactions between affiliates.

161. S. Surrey, W. Warren, P. McDaniel & H. Ault, supra note 159, at 675-76. The authors describe Gregory as constituting a "printed warning, 'Beware - Proceed with Caution', that faces tax reduction plans having any element of artificiality or non-conformance with normal business or family conduct." Id. at 672-73. They further describe why these are hard cases:

1) If the correct underpinning is present (i.e., the taxpayer cuts [no] legal corners and is [not] careless about the substance of each independent step) the problem is a difficult one. After all, a taxpayer may buy a tax-exempt security in a situation where the transaction makes economic sense only because of the interest exemption . . . . Thus, in some areas the Code provisions themselves are understood to establish new business norms though those norms are motivated by the tax result. But other provisions, such as the interest deduction . . . . must be understood as written only for those transactions whose business or economic norm or motivation is not derived from the tax law.

Id. at 675-76. See Rice, supra note 140, at 1038 ("The existence of a calculated plan to avoid taxes is the basic explanation for all of the cases concerning the effect of transactions which are commercially unfamiliar and comply with formal requirements for minimizing taxes under the statutes.").

162. The business purpose doctrine is often described as denying expected tax benefits with respect to a transaction with no business purpose. See Rosenberg, supra note 157, at 389-400. For an application of this definition to a captive case, see Humana Inc. v. Commissioner, 881 F.2d 247, 255 (6th Cir. 1989) ("Absent a fact pattern of sham or lack of business purpose, a court should accept transactions between related though separate corporations as proper . . . .")
between the two is required in order to solve this dilemma.

In order to illustrate the problem, consider an example of the circular lines of thought to which this area lends itself: if the subsidiary is organized to carry on an insurance business, it is not a sham and should be respected. As a separate entity it can make an insurance contract to bear the risk of another corporation, including an affiliate, because the making of an insurance contract has a business purpose if it contains standard risk shifting terms. But if the arrangement were to be considered as a whole, including the affiliated relationship of the contracting parties, there is no business purpose. The separate corporation and the "insurance" transaction need not be respected by the government.

The exquisite torture of such ideas may in practice be relieved in favor of the taxpayer’s position, because of the typical presence of some colorable\textsuperscript{163} business purpose.\textsuperscript{164} The captive usually performs functions that would give it a business purpose independent of its assumption of the risks of an affiliate, such as loss prevention, investment management, and insurance of unrelated parties.\textsuperscript{165} Indeed one of the reasons for the organization of a captive by a medical services provider, such as Humana Inc., was the advantageous treatment for Medicare reimbursement purposes that captives bring to its affiliates over self-insurance.\textsuperscript{166} This sort of business purpose might break this circle.

However, it may simply pose a tougher issue regarding the anti-tax avoidance analysis required to break the circularity of reasoning. As a general proposition, it is difficult to conceive of decisions made only for tax reasons. Generally decisions have at

\textsuperscript{163} It has been observed by some that one of the difficulties with the business purpose test is the ability of the taxpayer to assert a business purpose to suit the occasion. See Rice, supra note 140, at 1044; Summers, supra note 157, at 41.

\textsuperscript{164} It has been said that some of these conceptualizations may appear to be “mere semantic gamesmanship” but that “[s]tarting points are important.” Therefore, the taxpayer’s focus on the legitimate nature of the insurance company is misplaced, because the issue is whether risk has been shifted from the insured to the insurer. Barker, supra note 3, at 298-99. While this may be the issue, once the captive is considered a separate legal entity, it becomes difficult to see the lack of business purpose.

\textsuperscript{165} See Greene, Tax Problems, supra note 40, at 253 (a captive can serve to provide direct access to reinsurance markets and make a profit by offering insurance coverage to third-parties); Greene, Captives: The Long Swim Back and Other Opportunities, 20 FORUM 627 (1985) [hereinafter Greene, Captives] (tax law changes and their impact on captive insurance companies).

\textsuperscript{166} See Brief of Petitioner-Taxpayer at 11-12, Humana Inc. v. Commissioner, 88 T.C. 197 (1987) (Nos. 15292-80, 17130-82), aff’d in part and rev’d in part 881 F.2d 241 (6th Cir. 1989).
least some business purpose. Captives may then provide a situation where the question that must be answered is whether an asserted business purpose can be disregarded where it is not of sufficient weight in relation to the tax avoidance potential of the transaction in question.

4. Weighing Business Purpose Against the Potential for Tax Avoidance

The nature of this dilemma suggests that the issue requires a value judgment be made by weighing the sufficiency of a business purpose against the transaction's tax avoidance potential. Often, such a decision cannot be fully articulated or rationalized. The government's position, in relying upon Spring Canyon Coal through the use of arguments such as the economic family concept, is that substance or economic reality controls over form. The taxpayers argue that form controls, as the tax law generally recognizes transactions between separate corporate entities, with certain exceptions noted in the above discussion of the business purpose test, none of which the government seems to apply either directly or expressly. There are no other points in the analysis on which the two different lines of reasoning can be reconciled. The issue thus becomes a choice between two themes in tax law. The choice will ultimately depend on which theme is deemed to be more important in preserving the integrity of the tax system. The theme chosen at this juncture could control the results in almost all of the captive cases: if an economic reality approach is used, captives cannot insure affiliates, and if the Moline Properties concept is followed, all captives can insure anyone, affiliates and nonaffiliates.

A leading commentator suggests that utilizing anti-tax avoidance analysis is merely an attempt to avoid a difficult question by

167. See Gunn, supra note 61, at 738 n.20.
168. See Rice, supra note 140, at 1051 ("The major premises under which tax avoidance is frustrated in some cases and allowed in others are simply too ephemeral to be articulated."). See also Bittker, supra note 140, at 695 (Judicial criteria like "form," "substance," "business purpose," and "economic reality," "are more successful in establishing an attitude or mood than in suppling crisp answers to specific questions.").
169. See Barker, supra note 3, at 299.
170. See Bradley & Winslow, supra note 3, at 246-49; O'Brien & Tung, supra note 3, at 669-70; Sachs, supra note 3, at 59-61; Tinsley, supra note 9, at 149-50; FORDHAM Note, supra note 6, at 819.
171. This would extend at least to the single parent captive arrangements.
using a vague or broad doctrine. Assertions of tax avoidance may be overused "to avoid grappling with complex problems." The business purpose doctrine may also be a "doctrine of last resort, invoked only where no more concrete and measurable principle is available to lend respectability to the decision of the court." However, this Article does not adopt a course based simply on its ease.

Commentators criticizing broad anti-tax avoidance analysis sometimes assert that the cases can easily be explained on other grounds. The same commentators may recognize the merit of turning to an examination of motives in close cases, or as a last resort. By first analyzing the definition of insurance, this Article seeks to show that captive insurance is a subject fit for anti-tax avoidance reasoning.

B. The Conflict Cannot Be Avoided By Use of the Risk Shifting Element of the Definition of Insurance

Attempts to avoid the conflict between tax doctrines by defining insurance are unavailing. The matter has been exacerbated because the government, and some courts reaching the result advocated by the government, apparently see no conflict between the two doctrines in the captive arrangement.

Perhaps the strongest explanation for the failure to perceive this conflict is the "net worth" variation in the economic family concept. This attempt to avoid a conflict with Moline Proper-

173. Rice, supra note 140, at 1044. See R. Paul, Taxation in the United States 661 (1st ed. 1954) (purpose is generally irrelevant "except as motive may throw light upon equivocal conduct").
174. See, e.g., Gunn, Tax Avoidance, supra note 61, at 750. Professor Gunn offers the Goldstein case as an example that he characterizes as capable of resolution without reference to the anti-tax avoidance analysis because the payment pattern in Goldstein did not match that of a typical debt transaction involving interest payments. In that case, the "unusual" pattern for the borrowing was only a prepayment of interest, which is not very remarkable by itself. Professor Gunn notes that the borrowing was intimately tied to the purchase of the Treasury notes that yielded a lower rate of interest than the borrowing, and thus the borrowing should not be considered separately from the purchase of notes. Id. at 750-54.

The reason for defining a term so creatively stems from the lack of a business purpose. Otherwise, it is difficult to see why a given transaction should be recharacterized beyond its form. Thus, the suggestion of defining such terms does not appear to advance the analysis.
175. Gunn, Tax Avoidance, supra note 61, at 748-49; Rice, supra note 140, at 1044.
176. See Barker, supra note 3, at 284-86 (net worth idea is variation of economic family concept). The government usually offers expert evidence supporting the net worth
ties seems to be enjoying an upsurge in popularity. It represents a creative, but not fully satisfying use of the definition of insurance.

1. The Use of a Net Worth Test to Reconcile Moline Properties and the Economic Reality Concept

The best articulation of the net worth approach and its asserted consistency with Moline Properties lies in the Ninth Circuit's opinion in Clougherty Packing. To paraphrase the court, no conflict exists if one defines insurance as a device to remove the economic consequences of risk from an entity. That transfer of risk is not present in the captive cases because the parent owns the captive and its net worth is diminished dollar for dollar by any losses paid by the captive. This does not disregard the captive as a separate entity because the approach only requires the analysis of the parent's financial statements. At first blush, this sounds like a complete answer to the taxpayer's arguments about Moline Properties.

It is worth noting at the outset that the insurance literature did not appear to require the net worth explanation of insurance prior to the litigation of the captive cases. Insurance scholars apparently accepted the legal conclusion that affiliated corporations could insure with each other since they were considered separate legal entities.

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idea. However, it does not appear as a part of the Service's published ruling. See Rev. Rul. 77-316, 1977-2 C.B. 53. The explanation of the economic family approach appeared at least several years earlier. See O'Brien & Tung, supra note 3, at 683-85.

177. 811 F.2d 1297 (9th Cir. 1987), affg 84 T.C. 948 (1985).
178. Id. at 1305.
179. See Goshay, supra note 4, at 115 ("separate tax entity of the captive insurer would seem justifiable as long as" operated as a separate company). Goshay and others writing in the insurance and economics area have been cited as concluding that captives constitute self-insurance. See also Barker, supra note 3, at 271 n.12, 272, 283 n.63 (citing Goshay and authorities discussed below). That conclusion is not stated in the authorities cited. Goshay actually said that "it might be argued that captive insuring is the epitome of the self-insurance device." Goshay, supra note 4, at 80 (emphasis added). In addition, Goshay stated that captive arrangements have elements of both insurance and self-insurance. Id. at 85.

Similarly, other authors writing on insurance theory similarly do not equate captive arrangements with self-insurance. Professor Friedman does not mention the captive concept. M. Friedman, Price Theory 80 (1976); Friedman & Savage, The Utility Analysis of Choices Involving Risk, in Readings in Price Theory 57-96 (1952). Neither does Professor Pfeffer, who discussed self-insurance at length. I. Pfeffer, supra note 67, at 47, 52-53. If Professor Pfeffer had concluded that captives cannot offer insurance to affiliates that would be remarkable since he testified as an expert witness for the taxpayer in Humana. Humana Inc. v. Commissioner, 88 T.C. 197, 209 (1987), aff'd in part and rev'd
mitted that the government's economic family concept depends on an assumption of "piercing of the corporate veil." This conclusion is further supported by the inability of the courts in foreign countries to disallow the deductions on the basis of the definition of insurance. Nevertheless, the net worth theory can be refuted with more precision.

2. Criticism of the Net Worth Approach

The basic premise of this theory should first be scrutinized from the standpoint of finance authorities. The theory may falter at a very early and general stage, as authorities from the finance area generally do not advocate the proposition that the value of an enterprise moves dollar-for-dollar in the direction of the value of its assets. The value of a captive should turn as much on the

in part, 881 F.2d 247 (6th Cir. 1989). Bawcutt does deal extensively with captives. He treats them as an alternative to other devices which retain risk to some extent. However, Bawcutt does not expressly equate captive arrangements with self-insurance. P. BAWCUTT, supra note 28, at 26.

180. Bradley & Winslow, supra note 3, at 248 n.308 (quoting from Mobil Oil's trial transcript. Record at 2427, 2452-54, Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985) (No. 358-78)).

181. Captives in both Canada and Great Britain apparently can generate expense deductions for the premiums. Although the tax laws of those countries differ from U.S. tax law, their attempts to determine the meaning of insurance under our common language should be of some relevance.

The Canadian courts have considered at least two captive cases. See Consolidated-Bathurst Ltd. v. The Queen, 87 D.T.C. 5001 (Fed. Ct. App. 1986), rev'g in part and affg in part, 85 D.T.C. 5120 (Fed. Ct. Trial Div. 1985); Bonavista Cold Storage Co. v. Minister of National Revenue, 83 D.T.C. 89 (Tax Review Bd. 1983). Although the Consolidated-Bathurst court found that a captive arrangement, including a capitalization or indemnity agreement by the parent, negated a critical element of insurance, the court stated that the "adoption of [the economic family] concept would amount to a wholesale disregard of separate corporate existence" and the court was therefore "unable to say that in the 1975 taxation year [which lacked an indemnity agreement] risk did not shift and was not distributed." 87 D.T.C. at 5007.

A result similar to that in Consolidated Bathurst prevails in Great Britain. At an early point, an author observed that the British tax authorities lack the authority, either judicial or legislative, to attack the form of the captive arrangements. Finney, Captive Insurance Companies — A United Kingdom and United States Perspective, 1980 Brit. Tax Rev. 115, 127-29. This is consistent with the observation of another author that the British tax law is generally less aggressive than United States tax law in policing tax avoidance transactions. See Tiley, Judicial Anti-Avoidance Doctrines: Corporations and Conclusions, 1988 BRIT. TAX REV. 108. It is my understanding that the British tax authorities do not challenge the deductibility of premiums paid to captives for reasons such as those described in this paragraph. See Finney, supra, at 125-129.

182. Valuation is problematic, with widely divergent values often asserted for a given enterprise. V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 1-33 (1987); R. CLARK, CORPORATE LAW 453-54 & n.30 (1986). Generally, one would think that asset value is not
efficiency of its operations as on the amount of its assets.\textsuperscript{183} At best then, the net worth approach represents only a rough approximation of the economics of captive transactions.

Even if one believes that the Service is correct that economic reality controls and the net worth explanation is substantially correct, the net worth approach does not take the economic family concept as far as it needs to go. The explanation breaks down most clearly in the case of a brother-sister corporation insuring with another such subsidiary, a circumstance that has long troubled the Service in developing its approach.\textsuperscript{184} Such an affiliate does not suffer a loss in net worth when the captive pays a loss on its account. However, in economic reality, the risk and premiums did not leave the affiliated group and the substance of Spring Canyon Coal is still offended\textsuperscript{185} (if the affiliates are all collapsed together). The Service, and the cases which borrow from its economic family approach, such as Mobil Oil and Stearns-Roger, would therefore conclude that there is no insurance\textsuperscript{186} despite the lack of effect on

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The underlying value of the captive . . . rests with its operation as an insurance business. Any losses the parent and other insureds incur are predicted to a large extent and accordingly are reflected in the premiums the captive charges. As a result, the underlying value of the captive ought not to fall just because the captive pays a claim to the parent. In fact, the value of the captive, using a literal balance sheet approach, may actually increase because of a recent or expected influx of premium income from the various insureds or because losses are less than predicted.

Taylor, \textit{supra} note 7, at 450. Corporate lawyers concerned with valuation techniques also consider earnings prospects more probative of value than asset value. \textit{See} V. BRUDNEY \& M. CHIRELSTEIN, \textit{supra} note 182, at 1-33; R. CLARK, \textit{supra} note 182, at 453.

\textsuperscript{184} It was once suggested that if the Service could not devise a better way of handling cash exchanges between brother-sister corporations than by "characterizing such transfers as a dividend from the 'brother' (corporation) to the 'parent' (corporation) and contribution of capital from the parent to the 'sister' (corporation), the Service should reconsider the whole idea of denying the [Code section 162(a)] deduction." Gen. Couns. Mem. 35,629 (January 17, 1974).

\textsuperscript{185} An expanded description of the problem shows that it is somewhat deeper. Generally, there is no problem with brother-sister transactions, subject to scrutiny under section 482, because one's deduction is the other's income. In the captive situation however, one's deduction is not offset by the other's income due to subchapter L. Thus, viewed from the group perspective, the tax effect is the same as allowing a deduction for self-insurance. The \textit{Spring Canyon Coal} principle is, therefore, offended. \textit{See} Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930), aff'd 13 B.T.A. 189 (1928).

\textsuperscript{186} \textit{See}, e.g., Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985); Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985).
net worth.\textsuperscript{187}

This weakness of the net worth approach is shown by the Tax Court’s handling of the brother-sister situation. The Tax Court has recognized that the economic family concept infringes on the general application of \textit{Moline Properties},\textsuperscript{188} and has not been persuaded to adopt the net worth approach.\textsuperscript{189} When faced with a brother-sister fact pattern in \textit{Humana}, the Tax Court recognized it as being within the scope of the concern that prompted its adoption of a recharacterization approach.\textsuperscript{190} However, the Tax Court could not rely on the economic family approach or its net worth approach variant to recharacterize the premium expense. Instead, it disallowed the deductions because to do otherwise “would exalt form over substance and permit a taxpayer to circumvent our holdings by simple corporate structural changes.”\textsuperscript{191} This type of action by the court is simply \textit{ad hoc} decision-making with no guiding principle or control.

In this light, it is not surprising that the Court of Appeals seized upon this factual context and reversed the Tax Court in \textit{Humana}. Even the line drawn by the Sixth Circuit, however, is not fully satisfying. The decision fails to give clear deference to either substance or form. If the captive arrangements are troubling and the premium expense deduction should be denied for parent-subsidiary arrangements, the deduction should also be denied

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\textsuperscript{187} \textit{See} Crawford Fitting Co. v. United States, 606 F. Supp. 136 (N.D. Ohio 1985), action on decision, 1986-007 (January 8, 1986). The action on decision stated that:

The fact that as, in effect, brother-sister corporations, any gain or loss of Con-
stance [the captive,] has no effect on the net worth of taxpayer does not justify
the court’s conclusion that they were not members of a single economic family.
Brother-sister corporations are in the same economic family as much as are par-
ent-subsidiary corporations.

\textit{Id.}

\textsuperscript{188} Clougherty Packing Co. v. Commissioner, 84 T.C. 948, 963 (1985) (Hamblen,
J., concurring). \textit{See also} id. at 967 (Gerber, J., dissenting) (stating that the majority can-
not disregard the nature of the transactions between separate corporations “without crash-
ing head on into the holding in \textit{Moline . . . ”}).

\textsuperscript{189} \textit{See} Gulf Oil Corp. v. Commissioner, 89 T.C. 1010, 1032 & n.1 (1987).

\textsuperscript{190} Humana Inc. v. Commissioner, 88 T.C. 197 (1987), aff’d in part and rev’d in
part, 881 F.2d 247 (6th Cir. 1989).

\textsuperscript{191} \textit{Id.} at 213. Since Humana may have had a business purpose for its multiple
subsidiaries, it is difficult to characterize its chosen corporate structure as a simple attempt
at tax evasion or avoidance, thereby elevating form over substance. The Sixth Circuit, in
answer to the Tax Court, stated that it should “not focus on the relationship of the parties
\textit{per se} or the particular structure of the corporation involved.” \textit{Humana}, 881 F.2d at 255.
The decision in \textit{Humana} though, may do little more than encourage corporate families to
restructure to take advantage of the brother-sister analysis. \textit{See} Adler, \textit{supra} note 11, at 1.
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to brother-sister situations that present the same difficulties regarding substance. A distinction between parent-subsidiary and brother-sister arrangements would be an unlikely point for tax law to come to rest.

The examination of the brother-sister situation demonstrates most clearly that there is a conflict between form and substance in the captive situation. The appellate decision in Humana highlights this conflict. The net worth explanation does not prove that economic reality is the correct focus in all cases. Clever phraseology will not solve the captive problem. If we are to resolve the matter on a principled basis, we must face some tough questions.\(^{192}\)

While defining insurance has initial appeal, it is not possible to resolve the captive issue without implicitly importing notions of anti-tax avoidance. The transaction is open to attack not because of its terms, but because of the identity of the parties to the transaction and the provisions of subchapter L. If we truly consider the corporations to be separate entities, economic reality will not suffice either. For these reasons, it is necessary to turn to motive and business purpose.

C. The Choice Between Form and Substance in Transactions Between Affiliates

From the above conclusions, it is apparent that the tax law faces a difficult issue involving the conflict between form and substance, and the appropriate point to choose between them in the captive context. One cannot simply conclude that the tax law favors substance over form. The authorities giving life to that doctrine make it clear that it is not an unbounded general directive, but one designed to address transactions that are generally without business purpose.\(^{193}\) The entire concept of separate corporate

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192. A former Department of Justice lawyer who participated in the trial of the Mobil Oil case, and later wrote a law review article on the subject, apparently thought the net worth concept was not a simple solution to a difficult problem. He started his analysis by detailing the economic family idea and the net worth variation. He then proceeded for another 37 pages in an attempt to reconcile the denial of the insurance premium expense deduction with standard tax law principles. See Barker, supra note 3, at 284-324.

193. See Higgins v. Smith, 308 U.S. 473, (1940); Gregory v. Helvering, 293 U.S. 465 (1935). In Smith, the Court disallowed a loss claimed by a taxpayer from the sale of stock to his wholly owned and controlled corporation, noting that the government is not bound to the form adopted by the taxpayer. Instead, it may look at actualities where the transaction is deemed to be unreal or a sham. Smith, 308 U.S. at 476-77. As noted by Learned Hand, this does not mean that the government can insist that economic reality governs in all transactions between related taxpayers.
entities, treated as such by the tax law, rests upon both a respect of the form the taxpayer has chosen and the understanding that in reality a separate corporation is but a legal fiction. Substance is always contrary to transactions based on that fiction.

The corporate fiction has been broadly interpreted for valid reasons. If such a fiction as Moline Properties is recognized and relied upon by planners, its scope must not be so restrictive as to undercut legitimate tax planning. Tax planners have placed great weight on the separate entity concept. In fact, tax lawyers instinctively rely on the legal separateness of corporations. Most assume without serious analysis that any two corporations can enter into business transactions with the hallmark of an arm's length transaction, and accomplish the same results or business purposes as those made by unrelated parties. Indeed this promotes the free conduct of transactions that are often beneficial to society. This leaves a wide range of transactions untouched and governed by form, because some business purpose exists for the great majority of standard business transactions. Due to the predominance of the business purpose concept, it has been difficult for some tax lawyers to accept the government's view of captive arrangements, even if one recognizes that the growth of captives from the self-insurance concept indicates the existence of a tax

This language [referring to a quote from Smith] we later interpreted as meaning that "the Treasury may take a taxpayer at his word, so to say; when that serves its purpose, it may treat the corporation as a separate person from himself; but that is a rule which works only in the Treasury's own favor; it cannot be used to deplete the revenue . . . ." Again we were wrong; we neglected to observe that the corporate "form" must be "unreal or a sham," before the Treasury may disregard it; we had taken too literally the concluding language that it was the "command of income and its benefits which marks the real owner of property."

This error was made plain in the third decision of the Supreme Court — Moline Properties, Inc. v. Commissioner.

National Investors Corp. v. Hoey, 144 F.2d 466, 467 (2d Cir. 1944) (citations omitted).

194. See Bittker, supra note 140, at 713 ("[T]he Code accepts at face value so many fictions (e.g., the separate identity of corporations, the independence of all members of the same family, etc.), regularly imposing tax liabilities on this basis, that it impliedly authorizes taxpayers to act on the same fictions.").

195. As Professor Bittker noted it was Justice Holmes who "said in rejecting a taxpayer's request that the courts pierce a corporation's veil in a state tax case: '[I]t leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true." Id. at 713 (quoting Klein v. Board of Supervisors, 282 U.S. 19, 24 (1930)).

196. It was argued long ago that certainty was so important that form should be conclusive. See Underwood, supra note 142, at 341-42.

197. See Rice, supra note 140, at 1023.
avoidance motive for the transaction.\textsuperscript{198} The generous latitude usually allowed tax planners in relying upon form can be illustrated by comparing the types of transactions between related parties that have been challenged, even though such cases do not lend themselves easily to generalization.\textsuperscript{198}

1. Using Section 482 to Restructure Transactions Between Affiliated Corporations

Under section 482, the government can restructure transactions among commonly controlled parties and consolidate dealings between related corporations to reflect arm’s length dealings when the parties have disregarded corporate boundaries, or failed to charge a competitive price for goods or services flowing between the entities.\textsuperscript{200} Otherwise, the separate existence of the corporations is respected.\textsuperscript{201}

For example, a deduction for losses which are incurred when one party passes off assets to another related party for the sole purpose of creating a loss will be disallowed\textsuperscript{202} because such transactions have no purpose other than tax avoidance. However, normal business transactions between related parties involving extended performance on both sides, as well as potential nontax benefits or detriments for the form chosen, are respected.\textsuperscript{203} This

\textsuperscript{198} See generally Blum, \textit{supra} note 159, at 495 & n.26 (tax avoidance cannot be decisive if the corporation’s primary motive was otherwise).

\textsuperscript{199} See Bittker, \textit{supra} note 140, at 695, 704-06; Rice, \textit{supra} note 140, \textit{passim}.

\textsuperscript{200} See Your Host, Inc. v. Commissioner, 58 T.C. 10 (1972), \textit{aff’d}, 489 F.2d 957 (2d Cir. 1973); Marc’s Big Boy-Prospect, Inc. v. Commissioner, 52 T.C. 1073 (1969), \textit{acq.}, 1975-1 C.B. 2, \textit{aff’d sub nom}. Wisconsin Big Boy Corp. v. Commissioner, 452 F.2d 137 (7th Cir. 1971); Hamburgers York Rd., Inc. v. Commissioner, 41 T.C. 821 (1964) \textit{acq.}, 1965-2 C.B.5.


\textsuperscript{202} See Higgins v. Smith, 308 U.S. 473, 475-76 (1940); Crosby Valve & Gage Co. v. Commissioner, 380 F.2d 146, 148-49 (1st Cir. 1967), \textit{cert. denied}, 389 U.S. 976 (1967); National Securities Corp. v. Commissioner, 137 F.2d 600, 603 (3d Cir. 1943), \textit{cert. denied}, 320 U.S. 794 (1943); see also Gregory v. Helvering, 293 U.S. 465, 469 (1935) (transfer of assets by one corporation to another without a business purpose was a mere contrivance and not a reorganization).

\textsuperscript{203} See Standard Oil Co. v. United States, 130 F. Supp. 821, 823 (Ct. Cl. 1955) (respecting sale of products by gasoline manufacturer to subsidiary retailer to escape later effective manufacturer’s excise tax where motive for sale at the time was to avoid higher excise tax). Of course, a different result might be expected where corporate boundaries have not been respected by the taxpayer. \textit{See} Continental Oil Co. v. Jones, 113 F.2d 557, 562-64 (10th Cir. 1940) (arriving at a different result than \textit{Standard Oil} on facts involving
result holds even if the transactions are purely financial, such as a loan from one corporation to a related corporation even though the borrowing party might later claim a deduction for the interest expense.\textsuperscript{204} In those situations, the potential for income on one side offsets the deduction on the other.

2. Application of Substance Over Form to Captive Arrangements

Similarly, insurance involves not only the payment of the premium by one party, but also performance by the other in the event of a loss as well as other insurance-related services. It can also result in different treatment by state authorities or parties doing business with the entity. As discussed above, several business purposes may be served by a captive insurance corporation. Thus, one cannot conclude that captive arrangements totally lack a business purpose.

This review of authorities illustrates how difficult it is to disregard a corporate entity, or to collapse a transaction among affiliated corporations to its substance, by relying upon either section 482 or a lack of business purpose.\textsuperscript{205} Presumably, this is why the government and the courts have not used such an analysis in captive insurance cases.\textsuperscript{206} In order to chart a course for captive anal-

\textsuperscript{204} See Kraft Foods Co. v. Commissioner, 232 F.2d 118, 124-25 (2d Cir. 1956) (allowing the deduction of interest charged on note between related parties).

\textsuperscript{205} Professor Taylor has summarized the principles in this area as:

\textquote{Our tax law generally pretends that [affiliated corporations] are economically distinct because intercorporate payments are treated as if they had economic substance. Various Code provisions and numerous cases operate to prevent related corporate taxpayers from taking advantage of this apparent fiction. The general theme of these anti-abuse rules is that transactions generally will be treated in accordance with their form for tax purposes if (1) a real transaction is involved, (2) the transaction does not contain a disguised payment for something else, (3) the consideration is reasonable, and (4) no terrible abuse occurs.}

Taylor, Captive Insurance, supra note 7, at 451.

\textsuperscript{206} For example, the lower court in Stearns-Roger found the formation of and doing business with the insurance subsidiary motivated by business necessity, and found section 482 inapplicable. Stearns-Roger Corp. v. United States, 577 F. Supp. 833, 836 (D. Colo. 1984). The court then relied on the economic family argument to conclude that there was no insurance. Id. at 836-38. By concluding that substance controls over form, the
ysis among the anti-tax avoidance authorities, it is necessary to extend the transactional analysis.

D. The Difference Between Insurance And Other Transactions Between Affiliates — A Study of the Economics of Tax Abuse Rather Than the Definition of Insurance

In order to disallow the premium expense deduction, insurance transactions between affiliates must be distinguished from those transactions which are respected. The focus should be on the potential for abuse rather than theoretical definitions of insurance.

1. The Alleged Differences Between Insurance and Other Transactions Between Affiliates

Those favoring the government’s position see the need to account for the ability of affiliates to engage in other transactions. These advocates base their argument on the idea that insurance is different from all other transactions between affiliates. Because of such alleged differences, "insurance" is asserted not to exist in a purported insurance arrangement between affiliates.

Unfortunately, upon close examination this argument leads us back to the same issues that began our analysis. The government’s position includes statements that insurance "can only be understood in financial terms" and "deals solely with the downside of business activities" whereas "other activities provide the opportunity for a profit in addition to a risk of loss." By the conclu-
sion of such arguments, its proponents return to a form of the economic family concept with question-begging statements about the need to shift risk away from the enterprise, as if the insurance company were not a separate legal entity.

These arguments leave even a sympathetic reader unsatisfied, as indicated by the courts' failure to use them directly or explain why they are relevant. Thus, the issue cannot be resolved solely by studying the theoretical definition of insurance in light of the substance over form doctrine. Once it is accepted that a definition of insurance will not resolve the captive issue, the testimony and reports of the experts become irrelevant. In any event, these observations, based as they are on the assumption that the corporate veil is pierced, offer little help in solving this basic issue. We should not turn to economists and other experts, or try to define insurance so as to avoid the conflict. Since it is basically the conflicting doctrines of tax law that need resolution, the lawyers and the courts need to make the decision.

2. The Potential for Tax Avoidance in Captive Arrangements

Instead of pursuing elusive distinctions based on the defini-

affiliates. See Taylor, Captive Insurance, supra note 7, at 450.

209. Perhaps the most articulate published statement of the conclusions to be drawn from the differences of insurance as recounted in the text is:

Insurance is therefore unique in that it is the mechanism for transferring a feature of business which has only negative implications. When a business has obtained insurance, it has quite clearly separated these negative financial implications from its operations. However, when a corporation retains the risk either directly or indirectly through its insurance affiliates, the corporation has not separated these negative financial implications from its operations.

Barker, supra note 3, at 302. To the extent that this means that the negative effects will affect the balance sheet, this seems to be the same as the net worth variation with its limitations.

210. Considering a subsidiary corporation's life span from incorporation to liquidation, one might say that the parent never parted with the premiums or the risk since it all left the parent at one point, but returned later. However, the same statement could be made for any transaction between affiliates.

211. The Mobil Oil court which heard these arguments, concluded that insurance was a "unique risk transfer device" and that other "transfers between related corporations which are acceptable for tax purposes are not relevant." Mobil Oil Corp. v. United States, 8 Cl. Ct. 555, 564 (1985). The court did not distinguish the other transfers on any principle other than its conclusory statements. Id.

212. One may recall an old story about a group stranded on an island with only a can of food to sustain them. The other members of the party had various suggestions about how to extract the food from the can, but the economist's answer began: "[A]ssume a can opener." A. Polinsky, An Introduction to Law and Economics 1 (2d ed. 1989).
tions of insurance, we should focus on practicalities and common sense. The arguments about the theoretical differences between insurance and other transactions obscure the major practical difference between insurance and other transactions, which is the potential for tax avoidance. The largest tax benefit comes at the start of the transaction, as the deduction on one side is accelerated by the premium arrangement. Moreover, this benefit is achieved without the normal tax cost of a two-party transaction. The insurer does not generate income because it can take an immediate deduction when it sets up reserves for "losses incurred," which is still allowed on a discounted basis. In addition there is no downside for businesses contemplating a captive arrangement as compared to self-insurance other than the burden of administrative costs, even though some consequences may be different for some of the affiliates if they have a contract labeled insurance. This practical difference of insurance, should be the focus in analyzing captive insurance arrangements.

E. Potential Resolutions of the Captive Issue Based on Anti-Tax Avoidance Analysis

The special tax advantages captives provide under subchapter L are the reason for the concern and suspicion that surrounds their use. Due to this unique situation, captives present a potentially abusive arrangement that may warrant attack by the Service. Recognizing this point, there are two possible ways to resolve the single-parent captive issue and remain within the normal framework used for evaluating transactions that have both a tax avoidance potential and an asserted business purpose.

1. Respecting the Form of the Captive Arrangement

One approach would be to conclude that form in such cases is substance, therefore Moline Properties prevails. There may be

213. See O'Brien & Tung, supra note 3, at 683-84.
215. See Bradley & Winslow, supra note 3, at 257.
216. The brother-sister situation, discussed above is one situation involving a potential economic difference. Depending on the relative resources of the affiliates, a claim may be paid that would not otherwise be paid. See id. at 249. See also Abramowitz & Allen, supra note 97, at 332 n.42 (in insolvency proceeding of insurer, all insureds have equal priority in having claims paid, so for insurer writing unrelated business, owner-insured may receive "more or less than the capital and premiums it had committed to the company").
some concern that the tax advantage is disproportionately large relative to the non-tax economics of the transaction. But perhaps we should not be concerned about it since this benefit has been expressly provided to insurance companies by subchapter L of the Code. Congress should make any necessary corrections, since it was Congress that initially decided that insurance companies should be treated differently than other taxpayers. The belief that this tax treatment is simply "too good to be true" is simply not relevant, and any tax avoidance motive should be ignored.

This conclusion is further supported by the overall approach of the Code to affiliated corporations. The Code permits a group to elect consolidated treatment, and then polices abuses in transactions between affiliates by specific provisions such as section 482, which essentially reduces the terms of the transactions to an arm's length deal. One may conclude that the presence of this tax benefit is not troublesome and does not merit judicial intervention by denial of the premium expense deduction.

Additionally, this result has support in the Tax Reform Act of 1986. For insurance companies operating under the amendments, the deduction for losses incurred must be discounted to a present value amount, in contrast to the prior allowance of a full face amount of losses to be paid in future years. If the discounting is properly done, the insurer would receive treatment similar to that allowed to taxpayers who can take a deduction only in future years for such liabilities, even if that later deduction is for the face amount of the liabilities. This conclusion derives from the general proposition that a deduction currently for the discounted present value of liabilities to be paid in the future, is the economic equivalent of a deduction in the future for the face amount of that liability. Thus, with the potential for abuse reduced by the 1986 amendments, there is even less of an anti-tax

218. See Bradley & Winslow, supra note 3, at 245-57.
219. See Humana, 881 F.2d at 254 (substance over form analysis cannot be used whenever the Service "feels that a taxpayer is taking advantage of the tax laws to produce a favorable result"). This sort of argument has also been used in support of abandoning the business purpose doctrine as a judicially imposed requirement. BUSINESS PURPOSE Note, supra note 157, at 1096.
220. See Greene, Tax Problems, supra note 40, at 260 & n.19; Sachs, supra note 3, at 60.
223. See Bradley & Winslow, supra note 3, at 233; Gunn, Matching Costs, supra note 26, at 31 n.144; Jensen, The Supreme Court, supra note 26, at 254.
avoidance reason to look behind the form of captive arrangements.\textsuperscript{224} This deferential treatment of captive arrangements appeared unlikely in light of the number of court cases disallowing the premium expense deduction, at least until the Sixth Circuit’s decision in \textit{Humana}. The value judgment of the decision makers (apparently in fact, if not in word) had, up to that time, been to give economic reality priority over form, at least with respect to the single parent-single insured captive arrangement that operated under the former version of subchapter L. For that reason, we should develop the reasoning necessary for a second potential approach that reaches a different result.

2. Inquiry Into the Existence of a Significant Non-Tax Goal

In order to reach the conclusion that at least some captive arrangements should be reduced to economic reality, further explanation is required. The business purpose line of cases leads us to elevate the anti-reserve accounting/self-insurance cases over \textit{Moline Properties}. The reason for such a result is probably the high potential for tax avoidance in this situation. For the years prior to the 1986 amendment to subchapter L, Congress’ retention of tax advantages to insurers should not be taken as a sanction for continued tax avoidance which the courts can address if the abuse undermines tax policies clearly articulated by Congress.\textsuperscript{225} In any event, no one has argued that the existence of captive insurance companies was contemplated or sanctioned by Congress when it established the original subchapter L rules.

Controversies in taxable years governed by the former version of subchapter L, illustrate the need to use a business purpose analysis in light of the potential for tax avoidance. The possibility of abuse is reduced for years controlled by the 1986 amendments to subchapter L, but an argument could still be made that an avoidance potential remains. The ability to use a method of computing income denied to other taxpayers raises the suspicion that some advantage may be gained. At least one writer has concluded that


\textsuperscript{225} Congress has shown increasing concern over time value of money problems, a category into which this issue fits. See, e.g., I.R.C. §§ 461(h), 483, 1271-1275 (Supp. V 1987) (recently revised or created sections addressing different aspects of the time value of money).
such an advantage exists after the 1986 reforms.\textsuperscript{226} For example, the complex rules of subchapter L may still provide such an example in the discounting process for reserves, as the discounting is to be done based on the applicable federal rate that is derived from federal government borrowings.\textsuperscript{227} Because the creditworthiness of other borrowers is usually inferior to that of the government, the theoretically correct discount rate which is adjusted for higher risk would exceed the applicable federal rate, therefore the deduction would be overstated. Moreover, the insurance industry may yet succeed in otherwise subverting tax reform,\textsuperscript{228} and there is no reason why captive insurers should benefit from that circumstance.

For insurance arrangements subject to either the present or former versions of subchapter L, aggressive anti-tax avoidance analysis is required in order to challenge the taxpayer’s position. This attack on captives could draw on the anti-tax avoidance principles derived from cases recognizing that transactions designed simply to create a tax loss for the group, without an economic loss, are subject to special scrutiny.\textsuperscript{229}

This framework requires that we judge the sufficiency of the asserted business purpose and closely examine the motives of the taxpayer, rather than trying to determine if insurance is theoretically present. As a leading commentator has summarized, we could compare the “tax reduction objective” of the taxpayer with its “non-tax objectives,” and place the burden on the taxpayer to show “the existence and significance of any non-tax objective.”\textsuperscript{230} Using this analysis, “tax avoidance” exists “where the non-tax goals are of insufficient weight as balanced against the tax reduction goal,” and does not exist where there is a “demonstration that

\begin{itemize}
\item \textsuperscript{226} See Rolfe, Captive Insurance Companies: Disguised Self-Insurance?, 65 \textit{Taxes} 154, 161 (1987). This conclusion seems to be based on the ability of the insurer to take a current deduction in at least some amount. There was no inquiry into the potential equivalence of that deduction to a future deduction of a greater amount.
\item \textsuperscript{227} See I.R.C. §§ 846(c)(2), 1274(d) (Supp. V 1987).
\item \textsuperscript{228} See generally Sheppard, Property and Casualty Insurors Attempt To Undermine Tax Reform, 40 Tax Notes 450 (1988) (legislation proposed by the insurance industry would repeal the loss reserves discounting provisions of the Tax Reform Act of 1986).
\item \textsuperscript{229} See Higgins v. Smith, 308 U.S. 473 (1940); National Sec. Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943). The Sixth Circuit in \textit{Humana}, interpreted such cases as meaning that “a court cannot disregard a transaction in the name of economic reality and substance over form absent a finding of sham or lack of business purpose.” \textit{Humana}, 881 F.2d at 255. This interpretation requires a lack of business purpose before the transaction may be reduced to its substance.
\item \textsuperscript{230} Blum, \textit{supra} note 159, at 516-17.
\end{itemize}
the action in question did serve or plausibly could have served a significant non-tax goal.\textsuperscript{231} Such a test does not provide a precise test for all cases, as some with particular potential for tax avoidance may require “weightier non-tax goals than do others,” and with some cases we may even “regard the plausibility of a particular non-tax objective as so low that we eventually fashion a general rule that precludes ever giving any weight to that objective.”\textsuperscript{232}

An example of disregarding potential non-tax purposes due to the presence of a highly tax sensitive transaction exists in one of the leading cases dealing with economic reality in the tax law. \textit{Knetsch v. United States}\textsuperscript{233} has been interpreted as holding that the purported non-tax goal of borrowing the face amount of an annuity, purchased in order to create an option to annuitize a sum in the future, with the hope interest rates would later drop so that refinancing could be acquired at a rate below that of the annuity, “was not sufficiently plausible to merit consideration.”\textsuperscript{234}

With a flexible view of “business purpose,” we could answer the captive issue in a manner that is responsive to the general reactions to such arrangements. An approach would be to say that this is a highly tax sensitive situation where the asserted business purposes are simply insufficient to outweigh the tax avoidance purpose. Form does not control\textsuperscript{235} where the asserted business pur-

\begin{itemize}
  \item \textsuperscript{231} Id. Professor Blum noted that “[A]lthough our law has never developed an all-embracing principle that every action must pass an anti-tax avoidance threshold before qualifying for favorable tax treatment, traces of such a notion have been read into numerous statutory provisions.” \textit{Id.} at 515. Some commentators had suggested that “such illusive criteria” as motive were difficult to depend upon when not specified in the statute. See Sutherland, \textit{Taxpayers’ Motive as a Basis for Taxability}, \textit{8 INST. ON FED. TAX'N} 990, 991 (1950). Blum’s analysis demonstrated that this proposition was of “doubtful validity.” Blum, \textit{supra} note 159, at 515 n.80. This is also shown by his use of the \textit{Knetsch} case as related in the text \textit{infra}, accompanying notes 233-34.
  \item \textsuperscript{232} Blum, \textit{supra} note 159, at 517.
  \item \textsuperscript{233} 364 U.S. 361 (1960). \textit{See supra} text and accompanying notes 152-54 (discussing \textit{Knetsch}).
  \item \textsuperscript{234} Blum, \textit{supra} note 159, at 517-18. \textit{See also} Blum, \textit{Knetsch v. United States: A Pronouncement on Tax Avoidance}, 1961 \textit{SUP. CT. REV.} 135 (finding that the transaction had no benefit other than tax avoidance permits disregard of transaction but court’s characterization of the transaction as a sham does not aid the analysis).
  \item \textsuperscript{235} Professor Blum also noted a general problem:
    \textsuperscript{235} The purposeful activity approach may conflict with another principle of our tax system. In some situations, . . . we may wish to permit the form of a transaction to govern its tax consequences without an inquiry into whether non-tax goals are served by use of the particular form. It might appear that the two policies could be reconciled by holding that where form is to govern, it is to do so
\end{itemize}
poses are as limited as those described above.

3. Application of Anti-Tax Avoidance Analysis to Captive Arrangements

Perhaps requiring the taxpayer to demonstrate that, subjectively, their purpose was to shift risk to the captive would suffice. In the captive context though one might conclude that the enormous potential for tax avoidance outweighs any plausible business purpose to acquire insurance. An asserted business purpose is usually measured by whether the asserted non-tax goal could plausibly be achieved under the circumstances or whether "one in the actor's position could reasonably have believed that an asserted non-tax objective would be served by the course of conduct." Courts may even require that the actor subjectively entertained the non-tax goal at the time of the transaction.

In this light, the asserted business purpose of acquiring insurance has some problems. A manager buying insurance must have the purpose of shifting risk. While the corporations may be considered separate entities in terms of analyzing the economics of the arrangement, no manager in a corporate group could subjectively entertain the thought that by passing his risks off to an affiliate he has shifted risk to another. As an employee of the group he must view the entire group as the relevant firm. This interpretation of the intentions of managers is bolstered by the view of the

only if the action itself is purposeful. Accepting such a doctrine, however, would amount to abandoning the notion that in certain situations form alone is to control, regardless of any other considerations.

Blum, supra note 159, at 519.

236. Id. at 523. For example, in Aldon Homes, Inc. v. Commissioner, 33 T.C. 582 (1959), the Tax Court stated that:

We are convinced . . . from our study of all the facts and circumstances that none of the alleged advantages in the use of multiple corporations . . . constituted any actual business purpose in the instant case. The alleged business purposes impressed us simply as a lawyer's marshaling of the possible business reasons that might conceivably have motivated the adoption of the forms here employed but which in fact played no part whatever in the utilization of the multiple corporation structure.

Aldon Homes, Inc., 33 T.C. at 597-98.

237. See Blum, supra note 159, at 523 & n.105 ("[o]ccasionally, courts appear to insist that the asserted business purpose must have activated the transaction in question"). See also Weyl-Zuckerman & Co. v. Commissioner, 23 T.C. 841, 847 (1955) ("[i]t must be shown by satisfying evidence that the alleged business purpose was in fact entertained as a motivating factor by petitioner or its responsible representatives"), aff'd, 232 F.2d 214 (9th Cir. 1956) quoted in Blum, supra note 159, at 523 n.105.
managers responsible for the formation of captives, that they are engaged in a form of self-insurance.\footnote{238}

In fact, most large business corporations exploring risk management alternatives do not desire to pay the price required to shift substantial amounts of risk, even when using unrelated insurers. This becomes apparent when considering retrospectively rated policies, the predominant form of unrelated insurer coverage for large businesses.\footnote{239} Such businesses typically seek retrospectively rated arrangements with premium arrangements so variable that no real risk is shifted.\footnote{240} Among the reasonable choices available to a large business corporation, a choice involving real risk shifting is not often on the table. The business purpose analysis must then shift to secondarily asserted purposes.

Those purposes often constitute an impressive list,\footnote{241} but closer examination casts doubt on their importance. For example, better claims control and a desire to make a profit in the insurance business, do not necessitate the coverage of related risks with full insurance coverage. In addition, lowering costs by providing direct access to the reinsurance market is often cited as a reason for formation of a captive.\footnote{242} But retention of the risks, through either initial coverage and retention or reinsurance by the captives, is at odds with this asserted reason for using a captive. Moreover, the secondary business purposes could be satisfied by ceding away the related business on the reinsurance market, an arrangement that would permit a current deduction under the Service’s ruling position.\footnote{243} Finally, in terms of assessing the actual extent that such purposes motivate the captive arrangement, it is common knowledge that despite the possibility of listing several non-tax purposes for a captive, “the single reason that dominates all others in making decisions regarding the formation,

\footnote{238. See Mobil Oil Corp. v. United States, 8 Cl. Ct. 555 (1985).}
\footnote{239. Brief of Appellant at 44-45, Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985) (No. 84-1773) (summarizing testimony of expert witnesses of both parties).}
\footnote{240. Industry representatives might dispute this conclusion, but it can be inferred from literature in the area. See Davis, IRS Targets Retrospectively Rated Insurance Programs, CASH FLOW 37, 38 (April 1987) (“retros”, in order to secure the deduction for the insured, need to have more realistic premium ranges than those currently being written); R. GOSHAY, supra note 29, at 42 (retrospectively rated plans have such variable premium arrangements to attract would be self-insurers).}
\footnote{241. Greene, Captives, supra note 165, at 627.}
\footnote{242. Id.}
\footnote{243. Id. at 634.
form, or operation of a captive insurance company is taxes."244 Thus, the secondary purposes are not sufficient and anti-tax avoidance principles can operate to disallow the premium expense deduction.

If the tax law took this direction in the captive cases, it would be in line with a general trend in the area. There is a tendency to reach results that achieve a certain economic justice even if the form of a transaction is contradictory. A recent example is found in the Supreme Court's 1988 decision in *Commissioner v. Bollinger*245 where the Court held that individuals, operating as a partnership, who used a corporation to borrow money in order to circumvent a state's usury law, could still deduct the interest on the borrowing because the corporation acted as an agent with respect to the loan. Although this result may seem fair and is supported by the apparent designation of the corporation as agent on the loan documents, it is somewhat inconsistent with the treatment of the corporation as the borrower for state usury law purposes,246 and the parties' failure to pay the corporation an agency fee for its supposed agency services. In short, economic justice appears to be gaining on form and the *Moline Properties* doctrine.247

Measuring the tax avoidance in captive arrangements and causing the allowance of the premium expense deduction to hinge strictly on that factor, would also provide a tidy resolution for the captive cases. If we could conclude with certainty that the current version of subchapter L or some further refinement of it gave no undue tax advantage to insurance companies, later cases considering such arrangements could distinguish any earlier authority that dealt with arrangements possessing tax avoidance. At that point the Service should be concerned that the insurers' recognize their receipts as premium income, rather than nontaxable contributions to capital under Revenue Ruling 77-316.248 Therefore, both the income and deduction side of the transaction would have substan-

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244. Id. at 628.
tial importance.

To date, the taxpayers and the government have sought an all or nothing approach to the issue. The two sides are arguing past each other without fully appreciating the merit in their opponent’s position. Captives present a difficult anti-tax avoidance issue and should be addressed in those terms. In this light, either side’s position represents a plausible result depending on a subjective value judgment. The recognition of this framework though, is more important than the result reached.249

F. A Direct Anti-Tax Avoidance Rationale Allows for a More Flexible Approach — The Impact on Group Captives and Captives Writing Unrelated Business

The courts’ attempts to define insurance in order to disallow premium expense deductions in the captive cases has produced some difficulties. Such an approach not only produces a conflict with Moline Properties, but has failed to develop clear principles distinguishing between types of captives based on the use of insurance theory.

The use of anti-tax avoidance principles would allow for such a reasonable distinction, if one concludes that some such arrangements should not produce a deduction and others should. Premium obligations to some captives — such as those with unrelated business or diverse ownership — may by use of anti-tax avoidance analysis produce a deduction for its affiliates. Other captives may not produce such a deduction.

The courts have indicated some willingness to draw such a line.250 A recognition that the line is based on notions of anti-tax avoidance would be advantageous in making such distinctions. It would avoid the strained attempts to achieve justice by defining insurance. Such a strain is apparent in the Tax Court’s recent

249. The author at an earlier time concluded that form should prevail even in the single-parent captive context, essentially for the reasons stated at the beginning of this section. Bradley & Winslow, supra note 3, at 245-57. In the several years since the writing of that earlier Article, the growing number of single-parent captive cases arriving at the opposite result appeared to render that analysis untenable. The Sixth Circuit’s decision in Humana though, lends support to the earlier Article. But, it is important to develop, as that earlier Article did not, the full anti-tax avoidance analysis required to reach the result achieved in nearly all of the single-parent captive cases. This exercise should emphasize the great difficulty in dealing with this issue in other than conclusory terms.

Captive Insurance Companies

The Gulf Oil opinion, which appears designed to adopt an ill-advised compromise approach.

If business purpose is emphasized to distinguish a single-parent captive arrangement from insurance generating a deduction, there is no need to reduce all captive arrangements to economic reality. Whenever the asserted business purpose of shifting risk appears insufficient in relation to the potential for tax avoidance, the deduction for the premium may be denied. Factual variations may produce different results as unrelated parties insure with or own portions of the captive. That is not because of the nature of insurance, which theoretically could exist between any two entities, but because at some point a sufficient business purpose in the transaction can be found. This may not produce a bright-line distinction, but it is more honest and straightforward than attempting to hinge the denial on a strained definition of insurance.

This seems to be the general direction of the Tax Court judges, even if their reasoning is based on other concepts. In the series of Tax Court decisions starting with Clougherty Packing and Humana and running through Gulf Oil, we see a reaction by the Tax Court judges to a series of fact patterns ranging from single parent captives and brother-sister captives, to captives with unrelated business. It is apparent from Judge Gerber’s dissent in Clougherty Packing that a sizable minority of those judges would emphasize Moline Properties and recognize an insurance transaction with a captive that insures only its parent.251 From the majority opinion in Gulf Oil it appears that the minority in Clougherty Packing is joined by a few centrists, notably Judges Whitaker and Hamblen, when the captive writes significant coverage for unrelated parties.252 The lack of a consistent theory in these cases is apparent as the author of each majority opinion attempts to justify its position by a definition of insurance, rather than admit that each is weighing a tolerance for tax avoidance against an asserted business purpose.

The difficulties with the line of cases began with Clougherty Packing’s lack of a clear reason for denying the premium expense deduction in a single-parent captive situation. At its base, the majority in Clougherty Packing purports to be applying a “recharacterization” test to determine that the transaction is not

251. Clougherty Packing Co. v. Commissioner, 84 T.C. 948, 965-69 (1985) (Gerber, J., dissenting), aff’d, 811 F.2d 1297 (9th Cir. 1987).
252. Gulf Oil Corp., 89 T.C. at 1010.
insurance.\textsuperscript{253} Usually recharacterization of the form of a transaction involves a searching analysis of all the facts of a case, as when debt is recharacterized as equity.\textsuperscript{254} Although these opinions speak of considering all the facts of a particular case, the only fact that appears to have any weight is ownership by the insured of the insurer.

On the surface, the result sounds like the Tax Court has a firm rule implicitly grounded in economic reality, but it does not. Since the \textit{Clougherty Packing} decision, a majority of the Tax Court has consistently disclaimed the economic family concept.\textsuperscript{255} This leaves an absence of an expressed, unifying reason for the results achieved in these cases. Ultimately, the cases seem to turn upon an instinctive disbelief in the genuineness of the insurance nature of the transactions between affiliates.

The matter was not made any clearer by the Tax Court’s handling of the brother-sister situation in \textit{Humana}.\textsuperscript{256} The court’s holding that substance controls over form to prevent circumvention of the holding in \textit{Clougherty Packing}, might have been an expected extension of the earlier case.\textsuperscript{257} But since we still lack a rationale for the basic decision, \textit{Humana} does not help a great deal.

In any recharacterization test, one should expect that as the facts change the results change. The Tax Court in its last major captive case, \textit{Gulf Oil Corp. v. Commissioner},\textsuperscript{258} indicated that the presence of a sufficient amount of unrelated risks may change the result of prior cases and allow the captive to insure its affiliates. This idea is neither based on economic reality nor a firm respect of the \textit{Moline Properties} concept of a separate corporate entity. It is based on an offshoot of the definition of insurance and

\begin{itemize}
    \item \textsuperscript{253} \textit{Clougherty Packing Co.}, 84 T.C. at 959-60.
    \item \textsuperscript{254} See Caplin, \textit{The Caloric Count of a Thin Incorporation}, 43 Marq. L. Rev. 31 (1959); Plumb, \textit{The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal}, 26 Tax L. Rev. 369 (1971). See also Stinnett’s Pontiac Service, Inc. v. Commissioner, 730 F.2d 634 (11th Cir. 1984) (review of thirteen factors to be weighed in determining if an advance is debt or equity); Mixon v. United States, 464 F.2d 394 (5th Cir. 1972) (same).
    \item \textsuperscript{255} See \textit{Clougherty Packing Co. v. Commissioner}, 84 T.C. at 956, 959 (1985), aff’d, 811 F.2d 1297 (9th Cir. 1987). For a later disclaimer of the net worth variant of the economic family concept, see \textit{Gulf Oil Corp. v. Commissioner}, 89 T.C. 1010, 1032 n.1 (1987).
    \item \textsuperscript{256} \textit{Humana Inc. v. Commissioner}, 88 T.C. 197 (1987), aff’d in part and rev’d in part, 881 F.2d 247 (6th Cir. 1989).
    \item \textsuperscript{257} \textit{Id}. at 213-14.
    \item \textsuperscript{258} 89 T.C. 1010 (1987).
\end{itemize}
demonstrates the problems of attempting to handle this problem by defining insurance.

1. Group Captives and Coverage of Unrelated Risks

The issue presented by a captive's coverage of unrelated risks has been viewed by practitioners as a significant one since the Service at one time gave that factor considerable weight. The presence of the unrelated risks gave the captive arrangement more substance in the eyes of the IRS. A few years ago, this possibility appeared to be cut short by the Claims Court decision in Mobil Oil Corp. v. United States which implied that such facts were not material when it failed to discuss the issue in its legal analysis of the case, even though the parties clearly presented it. The Tax Court's majority opinion in Gulf Oil revived this issue by stating, in dicta, that a sufficient proportion of unrelated business can give the affiliates' transactions with the captive the characterization of insurance, with the further suggestion that this point could clearly be reached when the unrelated business accounted for fifty percent of the premiums.

In addition, the Gulf Oil majority apparently intended the scope of their reasoning to reach group captives. The opinion draws support for its fifty percent guideline from the Service's revenue ruling sanctioning the premium expense deduction for premiums paid to a group captive. As noted above, the group captive also presents a conflict, albeit a diluted one, between economic reality and separate corporate entities. An owner-insured making a contract with such an entity passes the risk to that entity, but continues to bear a portion of the risk through its ownership position. For that reason, it has been argued that the deduction for the insurance premium should be partially denied to the extent of the ownership interest, much as Judge Goffe argued that the Gulf

259. See Bradley & Winslow, supra note 3, at 242; Greene, Tax Problems, supra note 40, at 260-63.
261. See Barker, supra note 3, at 310; Bradley & Winslow, supra note 3, at 242.
263. Id. at 1027 n.14 (citing Rev. Rul. 78-338, 1978-2 C.B. 107). The court stated that the “sharing of premiums paid by unrelated insureds is similar in concept to a mutual insurance arrangement.” Id.
264. See Barker, supra note 3, at 306-07. Professor Barker notes that risks can be divided, retained, or transferred by reinsuring. From this observation, Barker argues that a contract with a group captive can be divided into insurance and self-insurance based on the
The majority of the court apparently feels that the presence of ownership in fact. The reinsurance process does not necessarily mean that Barker's point is proved. In that process, the risks are both retained and transferred in part in form and substance. With intercorporate transactions, a reason is needed to reduce matters to their substance if the form is different. One can reach this result by recalling the language used by the Ninth Circuit in Clougherty Packing which states that the "net worth" of the insured parent falls "dollar for dollar" by the amount of the loss paid by the captive. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1305 (9th Cir. 1987), aff'g 84 T.C. 948 (1985). One can conclude that to mean to that extent a loss affects the net worth of the parent, the payment is not insurance. That approach is not recommended by this Article because it would overemphasize an approach based on an asserted definition of insurance.

265. Gulf Oil Corp. v. Commissioner, 89 T.C. 1010, 1042, (1987) (Gofe, J., concurring). While Judge Gofe concurred in the denial of the premium expense deduction on the facts at issue, he objected to the dicta relating to significant unrelated business. Id.

266. "[T]o have insurance risk transfer and risk distribution must be present." Id. at 1023.

267. One might question whether the partial disallowance of premiums paid to a group captive adequately reflects economic reality. If the entire arrangement is analyzed for risk shifting, rather than an individual contract, none might exist. An owner-insured does not feel the extent of his risks transferred, except to the extent of its ownership position. However, by agreeing to enter the relationship and capitalize the captive with other businesses with similar risks, it agrees to take on the risks of others, so it may have much the same risk as before. The arrangement may spread a catastrophic loss in one period among all the members. That may be somewhat illusory if the rates for the next period are adjusted so that the insured pays for the losses of the group covered in the previous period. Over time, in all forms of insurance, apart from the handling of catastrophic loss, the premiums contributed by the group pay the losses. See Abramowitz and Allen, supra note 97, at 331-32; see H. Denenberg, R. Eilers, W. Hoffman, C. Kline, J. Melone, W. Snider, Risk & Insurance 143-44 (1964) [hereinafter H. Denenberg]. Perhaps this shows that insurance accomplishes less for an insured (i.e., is closer to self-insurance) than is sometimes perceived.
of unrelated business in a sufficient proportion can supply the necessary confirmation of genuineness, being a factor extrinsic to and independent of the affiliated group. There may be more confidence in the genuineness of the arrangement as the amount of unrelated business done by the captive increases because the captive then shows a greater amount of independence from the corporate group because its acceptance of outside risks indicates that it may gain or lose by its insurance endeavors. When a large enough number of unrelated parties purchase such coverage, the insurance program may be accepted for what it purports to be. To put words in the court's mouth: with that amount of unrelated business, insuring with the captive has a substantial business purpose outweighing the tax avoidance motive, and *Moline Properties* prevails.

This resolution of the captive cases with unrelated business is not an unreasonable approach to such a difficult issue. But it would be better for the court to recognize that this is what it is doing. The present course involves great difficulties. Large results appear to hinge upon fine distinctions in insurance theory, a theory which is not equipped to deal with such cases. Emphasis is placed on economic reality, yet that concept is often in conflict with other tax principles relating to intercorporate transactions.

2. The Current Position of the Tax Court

Although one can understand the desire of the Tax Court to compromise the issue at some point, the manner in which it is accomplished is troublesome. It did not adopt either the economic family approach or a *Moline Properties* separate corporate entities approach. An economic family approach would find that the risks of the affiliates remain in the economic family and therefore have not been shifted. Under *Moline Properties*, one might conclude that a risk can be shifted to any separate corporation. The *Gulf Oil* standard does not admit of such easy interpretation nor yield such clear results. While the approach recommended in this Article has a similar indefiniteness, the *Gulf Oil* approach has an additional flaw. It is based on an interpretation of insurance theory that does not appear principled or consistent.

The court used an unusual insurance theory to accomplish its

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268. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), aff'd 84 T.C. 948 (1985); Barker, supra note 3, at 300-15.

269. See *Moline Properties*, Inc. v. Commissioner 319 U.S. 436 (1943); Bradley & Winslow, supra note 3, at 249.
result. The presence of insurance, according to the *Gulf Oil* court, is based on the idea that one can combine its risks in a captive with the risks of others and it may pay less in premiums than its eventual losses.270 According to those interpreting the *Gulf Oil* court's dicta, even though an affiliate cannot generally shift risk or insure with a captive by merely passing its risks to the captive, it may achieve both under a "horizontal approach" to insurance in which the "insureds shift and distribute risks among themselves."271 The *Gulf Oil* court apparently believed that insurance involves a shift of risk to other insureds through the distribution process among the insureds.

3. Criticisms of the Tax Court's Definition of Insurance

The Tax Court's definition of insurance conflicts with the great bulk of insurance theory, including the Sixth Circuit's opinion in *Humana*, that views risk shifting as premised upon a vertical transfer to an insurer, with distribution constituting a separate issue.272 The *Gulf Oil* concept that risk shifting occurs through

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270. The *Gulf Oil* court stated that:

By adding unrelated insureds, the pool, from which losses are paid no longer, is made up of only the affiliated group's premiums. When a sufficient proportion of premiums paid by unrelated parties is added, the premiums of the affiliated group will no longer cover anticipated losses of all of the insureds; the members of the affiliated group must necessarily anticipate relying on the premiums of the unrelated insureds in the event that they are "the unfortunate few" and suffer more than their proportionate share of the anticipated losses.

Thus, when the aggregate premiums paid by the captives, affiliated group is insufficient in a substantial amount to pay the aggregate anticipated losses of the entire group, the affiliates and unrelated entities, the premiums paid by the affiliated group should be deductible as insurance premiums and should no longer be characterized as payments to a reserve from which to pay losses. Risk distribution and risk transfer would be present, and the arrangement is no longer in substance equated with self-insurance.


271. See Bradley & Taten, *supra* note 70, at 297.

272. See, e.g., Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986) (risk shifting means that one party shifts risk to another; and risk distribution means that the party receiving risk distributes its liability in part among others); H. DENENBERG, *supra* note 267, at 141 (risk transfer occurs when insured contracts with an insurer). See also Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987) (since the parent of a captive insurer retains an economic stake in whether a covered loss occurs, risk of loss is not shifted), aff'd 84 T.C. 948 (1985). In *Humana* the Sixth Circuit stated that: "[T]he tax court majority ignores the fact that risk shifting and risk distribution are two separate and distinct prongs. The tax court cannot collapse the two prong test into one and claim that the appearance of unrelated third-parties creates enough risk transfer." Humana Inc. v. Commissioner, 881 F.2d 247, 257 n.4 (5th Cir. 1989).
risk distribution can be inferred from language in a number of authorities, therefore it is plausible that the unrelated insureds bore some risk. But language suggesting that risk shifting may occur horizontally typically appears in cases when a separately recognized entity contracted to relieve an insured of its risks, or served as an intermediary in the pooling process. In contrast, if the affiliates and the captive are merged, under the economic family theory there is no separate entity to limit and make good the losses of the affiliates. All of the losses of the affiliates are paid by funds from the captive in the event that the affiliates suffer great losses. The affiliates' risks before the policy period are as unbounded as they would be absent such a transaction.

The writing of unrelated business means that the affiliated group has taken on additional risks as an insurer. To say that this results in risk shifting is to say that an insurer transfers its risks to the insured. Writers in insurance literature would say that by accepting the additional risks, all other things being equal, the captive's expected return is not changed, instead its absolute range of uncertainty or variability is increased by the added risks.

While it is true that the unrelated parties may contribute funds that exceed their losses, this is possible in any insurance arrangement. But the risks will generally be shifted to unrelated parties only if they are systematically overcharged.

Aside from fixed premium arrangements with an unrelated insurer, other insurance arrangements can be viewed as effecting a transfer of risk. Some commentators state that pooling, by itself, may transfer a risk. An example is the pure assessment mutual

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273. See, e.g., Commissioner v. Treganowan, 183 F.2d 288, 291 (2d Cir. 1950) ("manifestly this plan provides a distribution of the risk, for because of the plan the risk of premature death is borne by the 1373 other members of the Exchange, rather than by the individual") (emphasis added).

274. See Barker, supra note 3, at 312-15; Bradley & Winslow, supra note 3, at 243 n.88.

275. See Barker, supra note 3, at 312-15.

276. See Hofflander & Nye, Self-Insurance, Captives and Income Taxation, 51 J. Risk & Ins. 702 (1984). See also Barker, supra note 3, at 312-13 & n.204 (describes risk distribution as a function of the quantity and quality of the risk accepted and retained by insurance companies in exchange for the potential profit they can earn). Insurance and finance scholars believe the requirement of outside business is immaterial in economic results, but they note other twists in tax law. Hofflander & Nye, supra, at 702 n.2.

277. See Barker, supra note 3, at 312; Bradley & Winslow, supra note 3, at 243 n.88.

278. See, e.g., H. Denenberg, supra note 267, at 143 ("it might be argued that pooling, per se, may involve a transfer of risk . . . . [for] example . . . . the pure assessment
that provides a premium arrangement subject to adjustment based on the loss experience of the group.\textsuperscript{279} It may be argued that pooling in such a case exchanges the risks of individual members for the more predictable group experience.\textsuperscript{280} For our purposes, it seems that for any one member of such an arrangement, the risk has been shifted by the agreement of other members to the adjustable premium process, not solely by the pooling process.\textsuperscript{281} In the

\textsuperscript{279} Id.

\textsuperscript{280} Insurance scholars apparently differ “as to whether the pooling of combination of risks, per se,” transfers risks in this manner. \textit{Id.} at 143.

\textsuperscript{281} See Taylor, \textit{Captive Insurance, supra} note 7, at 451. Some commentators have argued that this position represents “one-dimensional economic views improperly ignor[ing] the more relevant fundamental dynamics of premium pooling.” Abramowitz & Allen, \textit{supra} note 97, at 331. They suggest that pooling unrelated risks within the captive shifts risks of the captive’s affiliates and that this position which the dicta in \textit{Gulf Oil} espoused, should be reaffirmed. Their conclusion is based on observations in the insurance literature to the effect that all insurance is in a sense mutual insurance because the group bears the losses through the premium pooling fund and, thus, the “insured” is also an “insurer.” \textit{Id.} at 330-33 & n.33 (citing \textit{inter alia} C. Kulp, \textit{supra} note 30, at 10; A. Mowbray, R. Blanchard & C. Williams, \textit{Insurance — Its Theory and Practice in the United States} 372 (6th ed. 1969); D. Reimnuth, \textit{The Regulation of Reciprocal Insurance Exchanges} 11 n.5 (1967)). They then note that for stock insurers, loss experience will affect premium rates for later periods so that as a group, insureds will pay the losses in the long run. Therefore in any period each insured in effect assumes the risks of the others through premium pooling. They conclude that the captive owner’s risks are “part of the pool . . . and thereby are shifted to the group.” \textit{Id.} at 331.

Messrs. Abramowitz and Allen fail to establish that their observations about pooling prevail over other aspects of the definition of insurance. The insurance literature generally seems to assume, sometimes explicitly, that the transfer of risk occurs by a contract between two parties rather than through the pooling process. \textit{See, e.g.}, H. Denenberg, \textit{supra} note 267, at 141 (“Insurance is defined . . . as the business of transferring pure risk by means of a two-party contract.”). Even where insurance authorities do not clearly express this concept, only an interpretation of their comments as requiring some form of coverage by a separate insurer could produce the reduction of uncertainty or limitation as losses that is specified in their definitions of insurance. \textit{See, e.g.}, C. Kulp, \textit{supra} note 30, at 10-11 (discussing insurance by transfer of risk or combination with others); I. Pfeffer, \textit{supra} note 67, at 52 (Defining insurance as “(1) a device mechanism, technique or principle; (2) designed to reduce the degree of uncertainty of the insured; (3) by means of the transfer of particular risks.”). The captive’s group does not experience a reduction of the uncertainty associated with its risks by the addition of unrelated risks to the pool. \textit{See Barker, supra} note 3, at 311-15 & n.204; Bradley & Winslow, \textit{supra} note 3, at 243 n.88. Finance and insurance scholars note no economic difference is accomplished by the addition of unrelated business. \textit{See Hofflander & Nye, supra} note 276, at 708-09.

Statements in some authorities to the effect that the insured is also an insurer should not be read literally. A self-insurer can pool its exposures but has not transferred them. H. Denenberg, \textit{supra} note 267, at 145. And unless the captive is considered separate from the purported insured, there is nothing resembling the standard transfer of risk contemplated in the insurance authorities. The long run substantial similarity between self-insurance, mutual insurance and insurance generally does not lead necessarily to the conclusion
captive context considered by *Gulf Oil*, it is clear that the losses of the operating affiliates will in any event be paid by those entities or the captive. The other unrelated insureds in a captive arrangement will not have their premium amounts adjusted as in a pure assessment mutual. Thus, risk shifting through the distribution process cannot be said to occur this way in the captive context.

The compromise nature of the analysis used by the *Gulf Oil* court is apparent from the cases in which the court indicated that the concept would result in risk shifting. The general test as set forth by the majority is that insurance occurs "when the aggregate premiums paid by the captive's affiliated group is insufficient in a substantial amount to pay the aggregate anticipated losses of the entire group, the affiliates and the unrelated insureds." 282 Although the court held that two percent of the premiums as unrelated business was insufficient for the years in question, 283 it stated that when fifty percent of the premiums come from unrelated sources, "we cannot believe that sufficient risk transfer would not be present." 284 At some unknown point between those two figures, the standard would be satisfied, yet there will not be anything truly different occurring as the figure rises from two to fifty percent. In this scenario, any choice is just an arbitrary line. 285 Indeed, a financial study of the addition of unrelated business, including up to fifty percent of the captive's coverage, concludes that this amount of additional business does not result in a reduction of the affiliated group's risk. 286

The indefiniteness of the *Gulf Oil* test may be the result of a discontinuity between the test and its asserted rationale. The test appears to turn upon the size of the unrelated business, but the

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283. Id. at 1028.
284. Id. at 1027 n.14.
285. See id. at 1042 (Goffe, J., concurring) ("I question why, under the majority's theory, some magical percentage of unrelated premium is critical . . . .").
286. Reduction of the affiliated group's risk can only take place through a combination of unrelated business and other risk management practices, such as an increase in policyholder surplus. This can be effected at figures much lower than fifty percent. Hofffander & Nye, supra note 276, at 707-08.
rationale in part turns upon the variability of the risk. The court's test implies that substantial unrelated business written by the captive indicates a commingling of funds to pay the risks of all, so that an insured is not simply getting its money back to pay its losses.\textsuperscript{287} The court is willing to give partial respect to the separate entity as long as there is some variability of risks between insureds, but the variability itself is not the test.

This confusion could be avoided by an anti-tax avoidance analysis. Theoretical definitions of insurance are ill-suited for explaining the different results reached by the Tax Court. Moreover, the courts generally have exhibited a low level understanding of insurance theory. There is no reason that the federal courts should be required to develop insurance theory in order to decide the captive cases, especially since the insurance scholars themselves are not unanimous about the subject.

In order to confirm that the use of other insurance concepts will not avoid the difficulties that have been encountered in the use of risk shifting element to analyze captive insurance transactions, those other aspects of insurance theory should be examined.

\textbf{IV. THE ROLE OF RISK DISTRIBUTION IN RESOLVING THE CAPTIVE ISSUE}

While the captive cases have almost exclusively focused on the risk shifting element of insurance, risk distribution may also add something to the analysis. In addition, an expansion on risk distribution may tell us more about the nature of cash flow programs in general.

\textbf{A. Absence of Risk Distribution Will Not Be Availing in Determining the Right to Deduction by a Purported Insured}

An absence of risk distribution is a potential reason for defeating the characterization of an organization as an insurer. Although the focus in the captive cases is generally on the perceived absence of risk shifting,\textsuperscript{288} according to Revenue Ruling 77-316,

\textsuperscript{287} Gulf Oil Corp., 89 T.C. at 1026 ("risk of each policyholder is divided into small units and is transferred to and distributed among the policyholders").

\textsuperscript{288} See, e.g., Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 n.5 (9th Cir. 1987), aff'd 84 T.C. 948 (1985); Stearns-Roger Corp. v. United States, 774 F.2d 414, 415 (10th Cir. 1985); Mobil Oil Corp. v. United States, 8 C.T.C 555, 566 (1985); Humana Inc. v. Commissioner, 88 T.C. 197 (1987), aff'd in part and rev'd in part, 881 F.2d 247 (6th Cir. 1989).
risk distribution is also absent in a single-parent captive arrange-
ment. Two Tax Court judges concurring in *Humana Inc. v. Commissioner* suggested that the absence of risk distribution pro-
vided the majority with a better reason for its result. This sug-
gestion has not been explored further, even though one of these judges, Judge Whitaker, wrote the majority opinion in *Gulf Oil*. A majority of scholars ultimately conclude that some form of risk distribution is required, but their phrasing of the risk distribution require-
ment often suggests that there is disagreement over whether the distribution is to take place among insureds or the separate risks.

289. See Rev. Rul. 77-316, 1977-2 C.B. 53. The Service stated that risk distribution was not present, but the cases do not focus on the distribution element. See Barker, *supra* note 3, at 308. The Sixth Circuit in *Humana* observed that “[t]here is little authority adequately discussing what constitutes risk distribution if there is risk shifting.” *Humana Inc.*, 881 F.2d at 256.

290. See *Humana Inc.*, 88 T.C. at 215 (Whitaker, J., concurring), *aff’d in part and rev’d in part*, 881 F.2d 247 (6th Cir. 1989); *id.* at 218 (Hamblen, J. concurring). The presence of these judges in the *Gulf Oil* majority, with the opinion written by Judge Whit-
aker, may indicate the need for a reconciliation of the suggestions concerning risk distribution in *Humana* with the majority’s opinion in *Gulf Oil*. Interestingly the Sixth Circuit in *Humana* found there to be risk distribution among the several corporate entities insured by the captive. 881 F.2d at 257. This possibility of risk distribution when there are several insured affiliates and the risk shifting hurdle is passed was suggested earlier. See Tinsley, *supra* note 9, 148-49. The Sixth Circuit stated that risk distribution “might not result” when a single-parent captive insures only its parent. 881 F.2d at 257.


295. Compare C. Kulp, *supra* note 30, at 10 (“Essentially, insurance is a formal social device for the substitution of certainty for uncertainty through the pooling of hazards . . . a large group of hazard exposures is required to permit pooling.”); R. Keeton, *supra* note 53, at 6 (“[w]ith an increasing number of ventures within a combined pool, the unusually . . . harmful experiences tend to stay more nearly in balance . . . .”); and H. Denenberg, *supra* note 267, at 143-45 (“self-insurer can pool his exposures, but he is still the ultimate risk bearer and therefore the scheme is not insurance”) with A. Willett,
1. The Origins of Risk Distribution

This disagreement among the theorists can be traced to the roots of the distribution concept in the "law of large numbers." This statistical principle permits increased predictability of expected aggregate covered losses as the number of individual covered risks increases.296 Under this principle, the number of independent risks covered is the key to predictability, not the number of insureds. For example, predictability may be fairly equal for an insurance company insuring the 10,000 cars of only one business and a company covering 10,000 insureds with only one car each.297 Thus, when an insurer has a sufficiently large number of risks such that great variations in aggregate losses are unlikely, and the premiums received plus its capital make it a viable risk bearer, one can say that risk distribution is present regardless of the number of insureds covered.

This interpretation is subject to criticism. It conflicts with the general notion that insurance is often described as a pooling of

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296. For elementary statements grounding this principle in the study of statistics, see T. Wonnacott & R. Wonnacott, INTRODUCTORY STATISTICS FOR BUSINESS & ECONOMICS 31-32, 55 (1972).

297. A. Willett, supra note 67, at 72. Willett stated that:

In many respects the increase in the number of distinct risks that an individual producer carries is analogous to the combination of the risks of many individuals. Other things being equal, a ship-owner who has a hundred ships, and who carries his own insurance, is in the same economic condition as any one of a hundred ship-owners, each possessing one ship, who have combined their risks in a group through a system of insurance. The gain from the combination of risks is due solely to the increase in the number of risks in the group; and if that increase takes place through the growth of a single industry, the same advantage is obtained.

Id. See also id. at 75 (gain from combination could be had by large insured). Distribution of such risks could also take place among risks covered in different policy periods. See Kulp, Social and Private Insurance: Contrasts and Similarities, J. AM. SOC'Y CHARTERED LIFE UNDERWRITERS 263, 267 (June, 1952).
risks by members of a group. The theoretical basis of the need for a group originates from the argument that regardless of the ability of a single entity to predict with some accuracy its own losses due to its numerous risks, uncertainty could be further reduced if that entity combined its risks with others to create a still larger pool. This group concept emphasizes what is called the societal aspect of insurance. This view is ultimately based not only on the addition of other parties for the benefit of the insureds, but also upon the decrease in the amount of funds required throughout society as a whole to be set aside to cover losses. If a court wished to uphold a challenge to a captive arrangement by use of a theoretical definition of insurance, a requirement of numerous unrelated insureds would be a decisive choice and one grounded in respectable insurance authority. However, there appears to be no movement in this direction.

2. The Problems With a Risk Distribution Analysis

A possible reason for the lack of movement relates to the definition’s theoretical inappropriateness for addressing the captive issue. The definition of risk distribution that emphasizes the societal view adds little substance to the analysis of any given contract with respect to the rights of the parties to the arrangement. From the insurer’s perspective, it can be said that adequate distribution is achieved once there is a sufficient number of independent risks from one insured to make the “law of large numbers” operate. At that point, it is a viable operation even if it chooses not to insure the risks of other persons. From the insured’s perspective, it has already reduced its uncertainty and transferred its risks by paying a premium and receiving coverage that protects it from greater

299. See A. Willett, supra note 67, at 75.
300. See Yale Note, supra note 74, at 784.
301. See A. Willett, supra note 67, at 73-83.
302. One reason for the lack of movement toward this theory may be that it would not support challenges to captives insuring sufficient numbers of unrelated insureds. It would however, seem capable of allowing the Tax Court to make the distinction that the court intended in the Gulf Oil dicta, suggesting risk shifting through the horizontal approach with sufficient numbers of unrelated insureds.
303. See I. Pfeffer, supra note 67, at 46-49; Denenberg Manuscript, supra note 53, at 52. Authors such as Pfeffer and Denenberg note that insurers place principal reliance on the “law of large numbers” to make the enterprise viable. Other factors cited as enabling the insurer to assume the risks include: superior knowledge, capital, and prevention.
losses. Although sufficient distribution among risks may assure the insured that the insurer is financially capable of bearing the risks purportedly transferred, this result can also be attained by any insurer with capital sufficiently great enough to absorb losses, whether or not other risks or parties are covered by that insurer.\footnote{304}{PFEFFER, supra note 67, at 46-49.} The transfer of the risks to a financially capable insurer is the important part of the transaction for the insured,\footnote{305}{See id. at 46 (goal of insurance is to distribute losses); Dennenberg, supra note 53, at 51 (from viewpoint of insured the primary emphasis is on risk transfer); YALE Note, supra note 74, at 784 (risk shifting emphasizes individual aspect of insurance).} and any requirement that uncertainty be reduced further is equivalent to requiring that it make a better deal by locating and contracting with an insurance company carrying a larger number of risks.

In light of this background, the course of the captive cases as they consider the insured's side of the transaction is not surprising. First, it is not unusual for courts in captive cases to avoid as uncertain a concept as risk distribution.\footnote{306}{See, e.g., Clougherty Packing Co. v. United States, 84 T.C. 948 (1985) (case decided on risk shifting and not risk distribution grounds), 811 F.2d 1297 (9th Cir. 1987).} Second, it is not unexpected for the courts to speak in off-handed dicta of the “distribution of risk among insureds” in the course of early captive opinions that turned on risk shifting,\footnote{307}{See, e.g., Stearns-Roger Corp. v. United States, 577 F. Supp. 833, 836-38 (D. Colo. 1984), aff’d, 774 F.2d 414 (10th Cir. 1985).} since a number of insurance authorities use similar descriptions. Third, it is not surprising that as the courts have become more familiar with insurance concepts, they have tended to describe the distribution process as taking place among independent risks rather than among unrelated insureds.\footnote{308}{See, for example, the statement of the Ninth Circuit in Clougherty Packing Co. v. Commissioner: Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. 811 F.2d 1297, 1300 (9th Cir. 1987), aff’d 84 T.C. 948 (1985). This language may be premised on the unspoken assumption that the numerous premiums would come from unrelated parties, but that fact is not necessary to the conclusion that it is the numerous independent risks that accomplishes the distribution process for the insurer.} In fact, the Tax Court in \textit{Gulf Oil} directly stated this conclusion, basing its reasoning on the “law of large numbers.”\footnote{309}{Gulf Oil Corp. v. Commissioner, 89 T.C. 1010 (1987) (distribution occurs among risks, and one insured with a sufficient number of unrelated risks can have sufficient}
This casual treatment of risk distribution as evidenced by the *Gulf Oil* language is justified. The parties to the contract obtain what such parties should expect from an insurance contract without the presence of additional insureds: (1) the insured reduces its uncertainty for a fee and (2) the insurer gets a fee for accepting a risk it is financially capable of bearing. The additional inquiry into the general societal effects of the contract, such as whether there is risk shifting and risk distribution *among insureds*, would not be an attractive question for courts to attempt to answer when deciding whether the insured can take a tax deduction for the premium expense. In this light, *Weber Paper*’s apparent acceptance of theoretical risk distribution as sufficient, given the bare presence of a number of apparently unrelated parties, is also understandable. If it is the number of risks that causes the “law of large numbers” to work and allows the insurer to spread its losses, the presence or absence of that possibility could be answered by statistical principles. The number of insureds that must be present, under the other view, is unrelated to the ability to predict the

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risks to achieve adequate distribution). See also Bonavista Cold Storage Co. v. Minister of National Revenue, 83 D.T.C. 89, 103 (Tax Review Bd. Can. 1983) (law of large numbers is based on number of risks, not numbers of insureds).

310. A simple risk shifting contract may be classified as a guaranty, whereas the acceptance of numerous such contracts may constitute the business of insurance, thus allowing the insured to deduct the premiums paid. See Note, *What Constitutes Insurance?*, 23 CORNELL L.Q. 188, 188 (1937) (Insurance contracts are created by engaging in spreading contractual risk over a number of people as opposed to a guaranty, which only shifts a duty.); Note, *An Analysis of “Insurance” and “Insurance Corporation”*, 36 COLUM. L. REV. 458, 458 n.10 (1936) (there is authority for the idea that only general operations of insurance and not isolated transactions are subject to insurance regulation). See also Denenberg Manuscript, supra note 53, at 83-85 (facts of isolation and lack of distributive scheme, should be only one factor considered when deciding if it is insurance).


312. The same absence of an in depth inquiry occurred in the Sixth Circuit’s *Humana* opinion, which held that risk distribution is required and suggests that it must take place among numerous insureds. The court, however, merely stated that: “[W]e see no reason why there would not be risk distribution in the instant case where the captive insures several separate corporations within an affiliated group and losses can be spread among the several distinct corporate entities.” 881 F.2d at 257. If that is the level of scrutiny to be given to the issue, it poses no difficulty of analysis.

The *Weber Paper* decision, however, appears to be a flawed application of insurance principles, since the issue should be the number and independence of the risks assumed by the insurer, matters not addressed in *Weber Paper*. Id. The insurer could fulfill its obligations in *Weber Paper* since, under the Service’s view, it merely had to return the funds each insured gave it. Overall this would seem to be a deposit arrangement rather than a risk shifting arrangement. Depending upon the time frame used for reference, the same conclusion could be applied to the other insurance arrangements discussed in this Article, but the Service generally has not pursued this argument.
losses.

This line of thought leads to one conclusion. The presence or absence of risk distribution should not be relevant in determining whether the transaction constitutes insurance from the standpoint of the insured for tax purposes. As indicated above, even among those insurance scholars who define insurance to include a combination of risks from numerous insureds, conclude that for the insured, risk shifting and the reduction of uncertainty is the essence of insurance. The insurer's failure to cover the risks of other insureds, thereby further reducing uncertainty and possibly premiums, suggests that a covered insured may simply have made a poor deal by contracting with that insurer. Similarly, the insured's failure to pay a high enough premium so as to leave some funds "in the pot" may mean it merely made a good deal. Those circumstances alone should not cause courts to deny insurance characterization to an insured.

Indeed, the concept of risk distribution is best understood in the aggregate. It is naturally thought of as involving a combination of risks assembled and borne by an insurer. Thus, if the concept has any bearing on the captive insurance issue, it is from the perspective of the captive insurer's characterization as an "insurance company." It is essential to the insurer that it be treated as an insurance company under subchapter L.

313. See A. Willett, supra note 67, at 79 ("The purpose of securing insurance is to avoid uncertainty. The insured buys security by the payment of a fixed premium, and after he has bought it his condition is not affected by the number of losses which the insurer may have to make good."); C. Williams & R. Hein, Risk Management and Insurance (1964). Williams and Hein state that:

Insurers are the major users of this device [of combination] for its own sake; they insure a large number of persons in order to improve their ability to predict their losses. In other words, the purchase of insurance, from the point of view of the insured, is a transfer; from the view point of the insurer, it is a combination.

Id. at 43.

314. With the presence of large numbers and the accomplishment of risk distribution, the expected outcome for each loss does not change, but the deviation or uncertainty decreases with the coverage of a greater number of risks. The expected losses figure does not decrease by adding further risks, rather it increases. See Barker, supra note 3, at 312 n.204. For an insured, the premium charged is generally the expected loss plus a loading charge. See Hofflander & Nye, supra note 276, at 703. In all forms of insurance, ultimately the losses are paid, almost exclusively, from the premiums charged to the insureds. See Abramowitz & Allen, supra note 97, at 331. If the insured is to recognize any savings through insuring with a larger insurer, it must be that the premium rate from an insurer with a larger number of risks would more nearly approach the expected mean for each insured.

315. See Bradley & Winslow, supra note 3; Greene, Tax Problems, supra note 40.
The absence of risk distribution should play a limited role in resolving the captive cases and cases involving other insurance products with similar characteristics. Even if the Service were to challenge the insurance company status of the arrangement, captives with large numbers of risks from various parties, or perhaps even one very large insured, will generally be able to argue that they satisfy a risk distribution standard that looks only to the number of risks rather than the number of insureds. If this version of risk distribution concept were to prevail, risk distribution would not play a large role in these cases. In *Gulf Oil* for example, the Service successfully challenged the taxpayer's deduction based on a finding that there was no risk shifting. This is despite the fact that the taxpayer had paid as much as $46 million in annual net premiums,\(^{316}\) and claimed that it had achieved sufficient risk distribution considering only its own risks.\(^{317}\) Outside of the captive context, third-party insurers will normally be able to satisfy the standard by covering numerous insureds and risks. The lack of risk distribution may be dispositive, however, when the captive insures a small number of risks of its affiliates and unrelated parties, such that the "law of large numbers" would not operate to make the estimation of losses predictable.\(^{318}\) Since this argument will only reach a subset of captive arrangements, the government has little incentive to argue aggressively about the lack of risk distribution. The government's prior litigation tactics indicate a desire to establish broad principles capable of reaching all single-parent

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317. *Id.* at 1046 n.4, 1046-47 (Nims, J., concurring). This argument appears to have been part of a claim that the presence of risk distribution itself constitutes insurance, apparently subsuming the risk shifting requirement. The argument was not vigorously pursued because the Tax Court had held in *Carnation* that there cannot be insurance without risk shifting. *See Carnation Co. v. Commissioner, 71 T.C. 400, 410 (1978), affg 640 F.2d 1010 (9th Cir. 1980).*

318. *Cf.* Bradley & Taten, supra note 70, at 298 (single parent captive receiving 99 percent of its premium income from insuring a single risk of an unrelated party may not have risk distribution under *Gulf Oil*). The circumstance described in the text resembles the kind of example that Judge Whitaker, had in mind when he discussed the absence of risk distribution and insurance, even though there might be risk shifting where one party contracted "to indemnify an unrelated party . . . from a specific risk." *Humana Inc. v. Commissioner, 88 T.C. 197, 217 (1987),* (Whitaker, J., concurring), *aff'd in part and rev'd in part,* 881 F.2d 247 (6th Cir. 1989) (emphasis added). Judge Whitaker assumed that "in order for the transaction to be economically sound for both parties, the premium would have to approximate the present value of the risk." *Id.* This is generally true of business insurance contracts under an expected present value analysis of the aggregate of risks covered. *See Hofflander & Nye, supra* note 276, at 703.
captives without regard to factual variations.\textsuperscript{319}

A somewhat broader and more appealing position for the Service would be that there is no insurance (perhaps focusing on the insurer's entitlement to treatment as an insurance company under subchapter L) in the absence of numerous insureds among whom the risks can be distributed. This view might be used to challenge captive arrangements without the presence of unrelated insureds and indirectly accomplish the same result as indicated in the \textit{Gulf Oil} dicta. This result can also be reached based on a respectable interpretation of insurance theory.

Even though this course is hampered by the difficulties, outlined in the preceding paragraphs, of including a requirement of numerous insureds as part of the element of risk distribution, the first of the single-parent captive decisions to reach this issue, the Sixth Circuit's \textit{Humana} opinion, suggested that requiring numerous insureds for risk distribution is appropriate.\textsuperscript{320} The court's application of the test was, however, rather lenient. The affiliates of the owner were counted as separate insureds. Without much analysis, the court simply concluded that "we see no reason why there would not be risk distribution in the instant case where the captive insures several separate corporations . . . and losses can be spread among the several distinct corporate entities."\textsuperscript{321} Under this application of the test, captive arrangements consisting of several corporate affiliates will meet the numerous insureds requirement, enabling more captive arrangements to survive scrutiny than if numerous insureds meant numerous "unrelated" insureds.

Given the difficulties of using the risk distribution element to winnow the cases, it will be necessary to resolve the risk shifting issue and to face the conflict with \textit{Moline Properties}. The absence of risk distribution is not legally dispositive, so that the Service cannot count on this as a ground for attacking captive arrangements. This suggests that other aspects of risk distribution should be examined to see if they can conclude this inquiry.

\textsuperscript{319} Cf. Barker, \textit{supra} note 3, at 289 n.85 (argument that captives are sham corporations lacking business purposes not acceptable to government as an attack on captives since it is too fact specific, and would not extend to captives accepting risks of unrelated parties); Bradley & Winslow, \textit{supra} note 3, at 245-57 (government has pursued litigation strategy in captive cases of establishing broad principles in weak cases in order to attack more substantial arrangements later).

\textsuperscript{320} \textit{Humana Inc.}, 881 F.2d at 257. The court stated that a single-parent captive insuring only the parent "might not result in risk distribution." \textit{Id.}

\textsuperscript{321} \textit{Id.}
B. The Presence of Risk Distribution is Not Clearly Implicated by the Captive Cases as a Ground to Deny an Insurance Characterization to the Transaction

If the absence of risk distribution is unavailing as a means of attack, the presence of risk distribution among an insured's own risks may further produce some surprising suggestions. It is possible that the ability of an insured to achieve distribution among its own risks may negate the insurance characterization of its transaction with an insurer. This prospect however, is only indirectly present in one of the captive cases and is better developed outside the context of the captive cases.

This prospect derives from some commentators' interpretation of the Gulf Oil standard that insurance is present when a captive writes more than fifty percent of its business for unrelated parties. Some have assumed that the standard is a safe harbor indicating the presence of risk shifting for insureds. This interpretation has been questioned where the insured owner of the captive has sufficient risks to have risk distribution among its own risks. In that event, the "horizontal approach" to insurance is less likely to work since the captive's owner probably will not have losses greatly in excess of those anticipated. If correct, this view would be a major limitation on the reach of the standard. This interpretation would mean that a large taxpayer, like Gulf Oil, might not be able to insure with its captive because its own risks are so numerous as to have attained a level of distribution.

Several reasons suggest that the court intended the fifty percent figure only as a safe harbor and did not intend to imply that the presence of risk distribution has the effect of denying the owner of the captive the ability to insure with its captive. First, even if a party's risks are sufficiently numerous to be reasonably predictable within a range, it still may suffer more or less than its proportionate share of losses. Second, it is difficult to comprehend why the court stretched to provide this piece of dicta if it did not intend some fairly firm standard.

Moreover, the Gulf Oil opinion contains nothing to support a conclusion that the court intended to make the major statement on insurance theory which has been suggested. Nothing in the

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322. See Abramowitz & Allen, supra note 97 at 333; Bradley & Taten, supra note 70, at 298.
323. See Bradley & Taten, supra note 70, at 298 n.11.
opinion indicates that the court was aware of this potential conflict between its statements relating to risk distribution and risk shifting. Indeed, the majority announced the standard in unequivocal terms. The size of Gulf Oil as a taxpayer should have suggested to the court that any statements concerning risk distribution should be explicit. Gulf Oil generated an annual net premium income as high as $46 million in one year. Given this size, it is likely that Gulf Oil attained risk distribution among its own risks, and it apparently made a similar argument at one point. Under these circumstances, one would expect the court to comment on Gulf Oil's potential problem of shifting its risks under the horizontal approach.

The possible ramifications of such an interpretation would also cause a radical rethinking of insurance theory outside of the captive insurance context. Assuming for the moment that the horizontal approach to risk transfer and insurance is otherwise valid, if an insured with risk distribution among its risks cannot shift its risks under that method because its aggregate losses are reasonably predictable, there is similar reason to doubt that such a party could transfer its risks directly even by a fixed premium contract with a third-party insurer. Yet a leading insurance theorist long ago observed that even a party with a large number of risks capable of distribution can achieve an economic gain by insuring rather than self-insuring. Such a party would be exchanging a larger potential loss for a smaller certain payment in the form of a premium, similar to other insureds.

325. Id. at 1021-22.
326. Id. at 1046-47 (Nims, J., concurring) (Gulf argued that "risk distribution was achieved both by the types of risks Insco insured and the parties who were insured. Gulf maintains that this should be true regardless of whether the captive insured unrelated parties"). Since Gulf's captive accepted only 2% of its premiums from unrelated parties in the years in question, it seems as if Gulf presented the court with the idea that it had sufficient numbers of risks for distribution. See also id. at 1046 n.4 (Gulf argued that risk distribution achieved risk shifting).
327. This might be thought to be a version of investment risk which according to the Court in Le Gierse did not constitute an insurance risk. Helvering v. Le Gierse 312 U.S. 531, 542 (1941). This concept was mentioned in Beech Aircraft Corp. v. United States, 1984-2 U.S. Tax Cas. (CCH) 1 9803 (D. Kan. 1984), aff'd, 797 F.2d 920 (10th Cir. 1986), where the captive purported to cover a layer of liability that was virtually certain to be incurred. The issue might be framed as whether the increase in numbers neutralizes the risk in the manner that the offsetting contracts did in Le Gierse.
328. A. Willett, supra note 67, at 75.
329. The Gulf Oil majority did note several descriptions of insurance that need re-
Nevertheless, a portion of such a large insured's coverage may have difficulty with some aspects of the insurance definition. Because of the large number of risks, any large insured is certain to suffer a given amount of losses. To that extent, events are not uncertain. These events may then be regarded as an improper subject of insurance, which is often described as covering only uncertain risks.\footnote{See I. Pfeffer, supra note 67, at 52; A. Willett, supra note 67, at 71.}

At this stage of development in the captive cases, such a conclusion should not be accepted as compelling. Although it is possible to use the terms in the manner described in the preceding paragraph,\footnote{See A. Willett, supra note 67, at 75.} one can also reconcile these large arrangements with the definition of insurance by observing that no event depending on future action is absolutely certain and insurance in these situations at least reduces the level of uncertainty.\footnote{See I. Pfeffer, supra note 67, at 46.} Moreover, one may also observe that the risk associated with any one property or activity is completely independent and therefore not affected by the fact that a group of risks is covered.\footnote{See R. Keeton, supra note 53, at 7. In that sense, each potential risk is covered at a "slight fraction" of its potential cost. A business may insure millions of risks and perhaps only hundreds result in a loss.} Each individual risk should be examined for purposes of determining the existence of risk shifting.\footnote{If this issue was even considered by the court, this interpretation seems to be conciliation with the statement in the text. Gulf Oil Corp. v. Commissioner, 89 T.C. 1010, 1026 (1987). In numerous general descriptions, insurance is characterized as accepting "each risk at a slight fraction of the possible liability upon it." Id. at 1026 (quoting Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 211 (1979)). It is also said that insurance allows substitution of a "small, definite cost (the premium) for a large but uncertain loss (not to exceed the amount of insurance) under an arrangement whereby the fortunate who escape loss will help compensate the unfortunate few who suffer loss." R. Mehr, Fundamentals of Insurance 32-33 (1983). This language can be interpreted to mean that each insured pays a premium that is only a small part of its potential loss. If a party has a sufficient number of risks to be reasonably predictable in an aggregate amount, it is not likely to find an insurer to cover them for a "slight fraction" of the aggregate amounts within the expected range. This type of definition of insurance should be taken as simply relating the facts in which insurance arrangements usually occur. It may be "a notion necessary to make the scheme work, rather than a description of a generic conception of insurance." Denenberg Manuscript, supra note 53, at 62. Denenberg describes one instance in which the premium was sixty percent of the potential loss. Id. at 56-57, 62. As Denenberg stated, the arrangement will not be practicable as the premium increases because the party will choose to self-insure rather than pay a premium that nearly equals the potential loss. This does not mean that a theoretical definition requires a small premium as compared to the potential loss. This merely suggests that at some point the risk becomes a certainty.}
"Gulf Oil" intended to make a major statement to the effect that large parties cannot purchase insurance.\(^3\)

The interpretation of the "Gulf Oil" dicta described above may represent the beginning of a promising line of analysis. But the court's opinion gives very little support for that concept. It would be premature to attempt to extract too much from it. In any event, the proposition is better examined out of the captive context, where there is no concern about the relation of the insurer and the insured.

**CONCLUSION**

Under certain conditions, an affiliate should be considered capable of insuring with a captive insurer within its corporate group.\(^3\) A definition of insurance, from the insured's view, should focus upon risk shifting. That term should be defined simply as the presence of a significant transfer from the insured to the insurer of one or more risks which present uncertainty. In order to ensure that an effective transfer of such a risk has taken place, the insurer must possess sufficient capital. The capital can be supplied either by the insurance company or through premiums paid. This ensures that the claims paid on behalf of any one insured do not simply represent a return of capital to that insured. In contrast, to be treated as an "insurer," a party must accept from one or more sources, a significant number of risks so that the aggregate result

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\(^3\)5. This should not be interpreted to mean that the risks are assumed by the insurer for less than their expected value. Judge Whitaker, the author of the majority's opinion in "Gulf Oil," seemed to imply in *Humana* that an arrangement where "the premium would . . . approximate the present value of the risk" meant that it was equivalent to "a reasonable self-insurance reserve." *Humana Inc. v. Commissioner*, 88 T.C. 190, 217 (1987) (Whitaker, J., concurring), 

"aff'd in part and rev'd in part," 881 F.2d 247 (6th Cir. 1989). The expected value of an event, however, never changes; the addition of numerous risks decreases the aggregate variability for the insurer. In practice, the insured "accepts a certain loss larger than the expected loss of its loss distribution (due to the loading of premiums) in exchange for elimination of the variance of its loss distribution during the policy period." Hofflander & Nye, *supra* note 276, at 703.

\(^3\)6. *Gulf Oil Corp.*, 89 T.C. at 1024 (noting the technical ability of affiliates to insure each other).
to the insurer is cast with the law of averages such that a distribution and spreading of the risks occurs. The definition of insurance for property and casualty insurance ought not be further embellished to deal with special arrangements such as captives.

Insurance concepts are not useful in distinguishing between purported insurance arrangements that the tax law should respect from those that it should not. Captives are merely one of several arrangements that can be structured with some of the characteristics of insurance in order to gain the tax benefits that such a characterization provides. It is difficult to scrutinize these arrangements for such characteristics and be comfortable with the decision.

The failure of all parties to fully recognize this problem has caused difficulties and obscured the real issue. In considering the captive cases, the courts have strained to base their denial of premium expense deductions on the absence of risk shifting. This process distorts insurance concepts. The real concern of tax avoidance has been ignored. We should not be defining insurance in these controversies, but measuring our tolerance for tax avoidance.

In the captive context, the tax law faces a conflict between economic reality and the form of the transaction. Because of the existence of plausible business purposes for such arrangements, captives present a difficult choice between form and substance. To disallow the deduction, we must be willing to find that the asserted business purposes are outweighed by the potential for tax avoidance.

Differences are beginning to develop among the captive insurance cases in terms of the formulation of the definitional issues and the results reached. The Humana case might have appeared to be an obvious vehicle for resolution of the captive insurance issue since it arguably produced a conflict between the circuits and might have attracted the attention of the Supreme Court. The government though, failed to file a certiorari petition in Humana, perhaps because the facts in Humana were distinguishable from previous cases and they did not present the strongest case for the government to present to the Court. Unless the govern-

337. See Taylor, Taxing Captive, supra note 3, at 859 (editor's note) (Humana inconsistent with other captive cases and "continued litigation and eventual Supreme Court review, absent Congressional intervention, is a virtual certainty").

338. See Adler, IRS Won't Seek Humana Review, Bus. Ins., Nov. 6, 1989, at 98, col. 4.
ment asks Congress to enter this conflict, subsequent cases may remove these difficulties and thus permit a majestic resolution of the captive insurance issue by the Court.

In this conflict, the advocates have not been willing to admit the merit in the other's position and an unproductive dialogue has resulted. Perhaps the greatest contribution that presently can be made is to point out the baffling nature of the issue. While a result for either side can be justified, it is important for the logical development of the tax law that the issue is faced directly. In the end, this should be viewed as an anti-tax avoidance issue rather than one involving the definition of insurance.

339. The government may turn directly to Congress as it did in the self-insurance area following its defeat in Kaiser Steel Corp. v. United States, 717 F.2d 1304 (9th Cir. 1983). See supra text accompanying notes 44-48.