The Captive Insurance Timeline: The Tide Turns for Taxpayers

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After several courts held for the IRS in captive insurance cases and denied the deductibility of premium payments, taxpayers started winning. Those taxpayer victories validated captive insurance structures, and is a frequent speaker and author on tax topics, including captive insurance companies. An economic family is similar to the concept of an affiliated group. An economic family theory.'').

This is the second article in a series on captive insurance case law development. In our first article, we reviewed early cases in which the IRS was able to successfully attack captive insurance structures using the economic family argument. The IRS won despite the fact that the captive insurance structures were clearly formed by insured parties who otherwise had severe difficulty locating comparable insurance. The economic family argument outlined in Rev. Rul. 77-316 provided that a wholly owned insurance subsidiary could not provide insurance (as defined by the courts) to any company that was in the same "economic family." An economic family is similar to the concept of an affiliated group.

The Balance Sheet Theory

After several attempts at getting the courts to accept an IRS legal theory as a valid means to ignore the captive’s separate corporate existence, the IRS eventually settled on the "balance sheet" theory. This theory applied if a parent corporation owned a 100 percent subsidiary captive insurance company, and the subsidiary captive insurance company made an indemnification payment to the parent. The IRS argued that the indemnification payment lowers the captive’s book value by the payment amount, thereby lowering the parent company’s value by the same amount (a 1-1 ratio).

The IRS was able to convince multiple courts to accept the balance sheet theory as the means to decide in the IRS’s favor. However, those IRS victories failed to address more complex ownership and insurance structures, such as a group of insured individuals owning the captive insurance company, or the captive insuring the risks of the parent and other "brother-sister" companies. Two later taxpayer victories explicitly addressed those issues.

The Crawford Fitting Case

The taxpayer in Crawford Fitting had a complex business structure with four manufacturing companies selling valves and fittings to four regional warehouses (named East, West, South, and Central) that sold products to independently owned distributors. Product liability insurance became prohibitively expensive, leading the companies to establish a subsidiary captive insurance company under Colorado law. Each regional distributor owned 20 percent of the captive with the remaining...
interests evenly distributed over four individuals who were executives of the parent company. Alexander & Alexander Inc., an insurance consulting company, established the premiums using actuarial information in the calculations. The IRS disallowed the deductions taken for premiums, and the parties ended up litigating the issue.

Unlike the ownership structures in the prior IRS victories, the Crawford Fitting captive was not a wholly owned subsidiary of the parent company; ownership resided with the four warehouses and several parent company executives. The IRS argued that those entities were in turn owned by individuals who directly owned Crawford, making the captive at least indirectly owned by the parent company. Thus, the IRS stated, the Crawford captive ownership structure should be treated no differently than in the prior captive cases the IRS had won. However, the court found that the actual separation was sufficient because “any gain or loss enjoyed or suffered by [the captive] does not affect the net worth of Crawford.” The large amount of risk underwritten by the captive bolstered the court’s reasoning; 70 percent of all the premiums were paid by:

Numerous companies that supply goods and services to the manufacturing companies, the 115 independent distributors of the Crawford products, the profit sharing trusts administered by Midwest Bank and Trust Company as well as A.P. Lennon, J.P. Lennon, C.L. Lozick and Edward Lozick.

Compared with the previous IRS victories, the diversity of risk added important transactional substance.

Crawford Fitting provided precedent for overcoming IRS objections to deductions for premium payments. Rather than creating the captive as a wholly owned subsidiary of the parent company, taxpayers could create and own a separate entity with the sole purpose of holding the captive shares (holding company). In the event of an indemnification payment, the holding company would be hit economically, but the parent company would be unharmed. Thus, the taxpayer’s premium payments were deductible, even though ownership of the Crawford Fitting captive was only one step removed from direct parental ownership. And any indemnification payment against the captive generated an indirect loss to the parent company — by harming the parent’s shareholders and related companies. From the IRS’s perspective, that indirect loss is still in the same economic family as the parent company.

The Humana Case

As in Crawford Fitting, the Humana hospital chain formed its captive for legitimate business reasons. Humana’s primary insurer informed the hospital chain three months before renewal that Humana’s coverage would not be renewed. The reasons for the non-renewal included (1) the increasing difficulty of planning for insurance payouts because of the longer lead time between setting premiums and the eventual payment of claims, and (2) the rise in plaintiff’s medical malpractice jury awards. From the insurer’s perspective, it was easier to not issue the policy.

Fortunately, Humana was already considering its options. It was unacceptable for Humana to be uninsured, because of potentially catastrophic potential payouts. Self-insurance was unattractive because reserve contributions were not deductible.Pooling its risks with other hospitals was also unattractive because it could have exposed Humana to financially weaker pool participants. Forming a captive insurance company was the only viable business solution.

Humana formed a captive named Health Care Indemnity under Colorado law. The company was capitalized with $1 million, which came from two sources: (1) $250,000 from an offshore subsidiary and (2) $750,000 from a letter of credit issued by the Humana parent company. Premiums were determined according to standard industry practice and documented via the issuance of standard insurance policies. Like Crawford, Humana’s corporate organization was a parent company with several subsidiaries. The captive was a subsidiary of the parent company, and it underwrote the risks of the parent company and the subsidiaries. The parent company paid more than $21 million in premiums over three years, covering 87 hospitals owned by 36 of its separate corporations.

Once again, the IRS challenged the deductibility of the premium payments made to the captive insurance company. At trial and retrial, the court distinguished between two types of indemnity payments: (1) those from the parent company to the captive and (2) those from the subsidiaries to the captives. The court held that the payments made by the parent company to the captive clearly fell within prior case law that disallowed deductions taken for those payments. The court held that the parent company’s balance sheet was not relieved of the risk of loss, stating that “as a shareholder of a wholly owned insurance affiliate, the parent company bears the risk of loss sustained by the subsidiary, suffers losses sustained by the subsidiary and

benefits from the gains realized by the subsidiary.”

Thus, there was no substantive shifting of risk between the parent company and the captive.

While the taxpayer lost at the trial court level on the deductibility of both payment types, the Sixth Circuit decided against the IRS on the payments from the subsidiaries to the captive. The appeals court stated that the subsidiaries were not shareholders of the captive, so there was no direct loss sustained by the subsidiary when the captive made a payment. Hence, premium payments made by the subsidiaries were deemed deductible. As in Crawford Fitting, Humana shows the clear shortcoming of the IRS balance sheet theory as the basis for the economic family doctrine. In relying on share ownership, instead of a broader, more malleable legal theory, the IRS had sown the seeds of their loss. Taxpayers with a diverse corporate structure could prevent application of the balance sheet theory, and by extension the economic family doctrine.

Conclusion

At its core, the economic family doctrine provided that even if a parent company established a captive insurance company for a viable business purpose, the captive should be disregarded for the deductibility of premium payments. The IRS sought to treat the captive as a reserve account on the parent company’s balance sheet in the guise of a separate corporation. However, this argument ran directly counter to the Moline Properties8 doctrine, which stood for the proposition that a separate company established with a valid business purpose should be upheld as such. The IRS needed a well-articulated and decisive legal rationale9 to overcome Moline, and it settled on the balance sheet theory.

The flaws in this theory were exposed in both Crawford Fitting and Humana. In Crawford Fitting, the taxpayer overcame the balance sheet theory by placing the captive ownership in a non-parent entity. This was extended by the Humana decision, in which premium payments made by a subsidiary were held deductible because those entities didn’t own captive shares. Over time, the IRS’s absolute prohibition on deductions for insurance premiums paid to a wholly owned insurance subsidiary have continued to run headfirst into the economic reality that companies form captives for valid business reasons.10 Despite IRS objections, advisers saw captives as a viable option leading to their continual recommendation of the practice. As captive insurance has become a commonly accepted financial planning device, states have passed more captive insurance enabling statutes.

10Ocean Drilling and Exploration Co. v. United States, 24 Cl. Ct. 714, 715 (1991) (“Because of the limited experience in insuring the new rigs and a number of substantial losses on these rigs, insurance rates increased sharply”); Kidde Industries Inc. v. United States, 40 Fed. Cl. 42 (1977) (“In 1976, in the midst of a products liability insurance crisis in which many insurance companies either ceased or significantly restricted their coverage of products liability. . . . Travelers informed Kidde that it would not renew Kidde’s products liability insurance policy for 1977.”); Malone and Hyde Inc. v. Commissioner, T.C. Memo. 1989-604 (“By the mid-1970s, the Hyde Insurance Agency found that insurance premiums were increasing each year and certain insurance was not obtainable for some clients”); Mobil Oil Corp. v. United States, 8 Cl. Ct. 555, 556 (1985) (After determining that “the outside insurance purchased by Mobil Overages was not bought efficiently,” the company commissioned an internal report. “The Adams Report concluded the methods of Mobil Overseas and its affiliates of insuring against physical damage should be revised. The report states (in part): Mobil Overseas should . . . [form an insurance affiliate to cover our risks where possible].”); Beech Aircraft Corp. v. United States, No. Civ. 82-1369 (D. Kan. July 3, 1984), aff’d, 797 F.2d 920 (10th Cir. 1986) (Beech aircraft was sued for product liability. The company’s insurance policy granted the insurer complete control of the attorneys used in litigation. Beech tried to remove counsel before trial, but the motion was denied. Beech formed the captive after it lost the case and a $25 million judgment.).