

REV-RUL, 2001FED ¶46,475, **Deductions: Insurance companies: Risk shifting: Captive insurance transactions: Premiums, deductibility: Economic family theory.--**, Revenue Ruling 2001-31, 2001-1 CB 1348, (June 04, 2001)

Revenue Ruling 2001-31, 2001-1 CB 1348, June 4, 2001.

[Code Secs. 79 , 162 , 165 , 301 , 816 and 831]

Deductions: Insurance companies: Risk shifting: Captive insurance transactions: Premiums, deductibility: Economic family theory.--The IRS will no longer invoke the economic family theory with respect to captive insurance transactions. No court, in addressing a captive insurance transaction, has fully accepted the economic family theory set forth in Rev. Rul. 77-316 , 1977-2 CB 53. The IRS may, however, continue to challenge certain captive insurance transactions based on the facts and circumstances of each case. In Rev. Rul. 77-316 , situations were presented in which a taxpayer sought insurance coverage for itself and its operating subsidiaries through the taxpayer's wholly-owned captive insurance subsidiary. The taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented one "economic family" for purposes of analyzing whether transactions involved sufficient risk shifting and risk distribution to constitute insurance for federal income tax purposes. The ruling concluded that the transactions were not insurance to the extent that risk was retained within that economic family and, thus, the premiums paid by the taxpayer and its non-insurance subsidiaries to the captive insurer were not deductible. Rev. Rul. 77-316 , 1977-2 CB 53; Rev. Rul. 78-277 , 1978-2 CB 268; Rev. Rul. 88-72 , 1988-2 CB 31; and Rev. Rul. 89-61 , 1989-1 CB 75, are obsoleted. Rev. Rul. 78-338 , 1978-2 CB 107; Rev. Rul. 80-120 , 1980-1 CB 41; Rev. Rul. 92-93 , 1992-2 CB 45; and Rev. Proc. 2000-3 , I.R.B. 2000-1, 103, are modified. BACK REFERENCES: ¶6367.44 , ¶8522.028 , ¶8522.392 , ¶8522.3945 , ¶9104.161 , ¶15,305.68 , ¶26,003.10 , ¶26,003.615 , ¶26,003.63 and ¶26,135.12 .

In Rev. Rul. 77-316 , 1977-2 C.B. 53, three situations were presented in which a taxpayer attempted to seek insurance coverage for itself and its operating subsidiaries through the taxpayer's wholly-owned captive insurance subsidiary. The ruling explained that the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented one "economic family" for purposes of analyzing whether transactions involved sufficient risk shifting and risk distribution to constitute insurance for federal income tax purposes. *See Helvering v. Le Gierse*, 312 U.S. 531 (1941). The ruling concluded that the transactions were not insurance to the extent that risk was retained within that economic family. Therefore, the premiums paid by the taxpayer and its non-insurance subsidiaries to the captive insurer were not deductible.

No court, in addressing a captive insurance transaction, has fully accepted the economic family theory set forth in Rev. Rul. 77-316 . *See, e.g., Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989); *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987) (employing a balance sheet test, rather than the economic family theory, to conclude that transaction between parent and subsidiary was not insurance); *Kidde Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997). Accordingly, the Internal Revenue Service will no longer invoke the economic family theory with respect to captive insurance transactions.

The Service may, however, continue to challenge certain captive insurance transactions based on the facts and circumstances of each case. *See, e.g., Malone & Hyde v. Commissioner*, 62 F.3d 835 (6th Cir. 1995) (concluding that brother-sister transactions were not insurance because the taxpayer guaranteed the captive's performance and the captive was thinly capitalized and loosely regulated); *Clougherty Packing Co. v. Commissioner* (concluding that a transaction between parent and subsidiary was not insurance).

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 77-316 , 1977-2 C.B. 53; Rev. Rul. 78-277 , 1978-2 C.B. 268; Rev. Rul. 88-72 , 1988-2 C.B. 31; and Rev. Rul. 89-61 , 1989-1 C.B. 75, are obsoleted.

Rev. Rul. 78-338 , 1978-2 C.B. 107; Rev. Rul. 80-120 , 1980-1 C.B. 41; Rev. Rul. 92-93 , 1992-2 C.B. 45; and Rev. Proc. 2000-3, 2000-1 I.R.B. 103, are modified.

DRAFTING INFORMATION

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