Captivating Deductions

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I. INTRODUCTION

The ability of corporations to reduce taxes using techniques that make aggressive use of complex structures and tax havens is receiving renewed attention.¹ This Article examines a technique that has drawn

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Although the new legislation introduced changes that may render the use of foreign captive
less scrutiny but that, like the use of corporate inversions, makes use of subsidiaries and illusions of timing: the conversion of non-deductible savings into deductible insurance premiums. This savings conversion mechanism is generally labeled captive insurance, but as this Article explains, the issue extends beyond the use of related insurance subsidiaries to include insurance contracts that are, in substance, designer investment contracts.

The differential between the income tax treatment for saving and that applicable to paying insurance premiums drives this conversion strategy. Businesses generally may not deduct transfers of cash into savings accounts or purchases of long-term investments, even if entered into for business reasons. In contrast to this tax treatment for investing, premiums paid by insurance companies less attractive, the legislation did not directly address captives and will have less impact on domestic captive arrangements (and on foreign captives taxed as U.S. corporations).

See infra notes 66-67 and accompanying text.


5. See infra Part II.A.


7. I.R.C. § 61(a). Corporations would be eligible for the dividends received deduction if the interim return takes the form of a corporate dividend. Id. § 243. The amount of the deduction varies depending on the extent of the ownership ties between the distributing corporation and the recipient corporation. Id. Several other rules also constrain the dividends received deduction. See, e.g., id. §§ 246, 246A, 1059; id. § 301(e) (Supp. III 2016). The 2017 tax legislation reduced, but did not eliminate, the dividends received deduction amount if the corporations are not in the same affiliated group. H.R. 1, 115th Cong. § 13002 (to be codified at I.R.C. § 243 (a)(1), (c)(1)).
for property insurance have been expressly deductible since virtually the 
inception of the income tax, and the policyholder is not taxed on any 
returns earned on the premium once it is inside the insurance company. 
As a result of the difference in treatment between savings and premiums, 
businesses have an incentive to create structures that take the form of 
insurance but that have the substantive features of an ordinary 
investment. For example, a parent corporation might create a wholly 
owned insurance subsidiary that provides coverage for a single insured—the parent. Because of the control the parent exerts over such a 
subsidiary, in substance, the parent is using the insurance subsidiary as a 
piggy bank; the parent thus should not get a deduction for putting cash in 
it and should pay tax on any investment returns generated on its 
“premium.” Although this simple version of the savings conversion 
strategy is no longer viable, it has given rise to multiple variations, many 
of which have survived judicial scrutiny.

The current approach of the Internal Revenue Service (“IRS”) has 
been to focus on defining “insurance” and then to test the substance of a 
particular arrangement against its definition. The IRS ties its definition 
to insurance concepts such as risk pooling and risk shifting. Businesses, however, have the ability to utilize related, separate entities 
to create artificial risk shifting and artificial risk pooling. The IRS has 
tried to craft definitions of risk pooling and risk shifting so that 
overly artificial arrangements will no longer qualify as insurance. Two 
obstacles, however, severely limit the ability of the IRS to combat the 
conversion of savings into deductible premiums through this strategy of 
imposing a particular definition of insurance.

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8. See Scott Taylor, Taxing Captive Insurance: A New Solution for an Old Problem, 42 Tax 
LAW. 859, 887-89 (1989) (noting that the Treasury expressly permitted deductions of business-
related insurance premiums since at least 1919); infra Part II.A (discussing the tax treatment of 
industry property insurance).

9. Of course, if the insurance contract is paid out, the proceeds will be brought into the 
policyholder’s tax computations. The policyholder may, however, first treat the proceeds as a 
nontaxable return of investment rather than taxable income (i.e., recovery of basis, in tax jargon). 
Further, the policyholder may be able to postpone any gain realized through electing to purchase 
qualifying replacement property. I.R.C. § 1033.

10. See infra Part II.B.

11. Because of the intense discussion surrounding the Affordable Care Act, insurance terms 
that were once arcane have now entered into mainstream discourse. See, e.g., Carolyn Johnson, 
What Health-Care Companies Wanted, and What They Got, in the GOP Bill, WASH. POST, Mar. 8, 
2017, at A6; Paul Krugman, Obamacare Hits a Pothole, N.Y. TIMES, Oct. 28, 2016, at A27; see 
also infra Part II.B.

12. See Taylor, supra note 8, at 901-04. Of course, any savings reserves created as a result 
will serve as a real buffer against future losses.
First, the courts adhere strongly to a long-standing, interpretive doctrine recognizing the separate tax identity of each business entity.\textsuperscript{13} Thus, even though a closely related group of entities may substantively function as a single economic person, courts will generally recognize each entity within the group as a separate economic person.\textsuperscript{14} Second, insurance remains primarily a state law concern, and state (and foreign) insurance regulators have increasingly recognized captive insurance arrangements as legitimate and aligned with their goals, which are different from those of the IRS.\textsuperscript{15} Insurance for purposes of state law regulation is also an undefined concept; in practice, a product receives the insurance label by states if state insurance regulators determine the product is within their purview.\textsuperscript{16} Because the IRS relies on non-tax insurance concepts to determine premium deductibility, courts have been hesitant to disallow tax deductions if a state or foreign insurance regulator has recognized a particular arrangement as "insurance."\textsuperscript{17}

This Article explores how moving away from reliance on a particular definition of insurance and towards normative income tax principles provides a clearer path to policing the boundaries between savings and insurance contracts for income tax purposes.\textsuperscript{18} Even though the deductibility of property insurance premiums for businesses has been a long-standing feature of the income tax landscape, the rationale for this deductibility has received little scholarly scrutiny. This Article takes a step toward filling that gap by evaluating insurance premiums in terms of a normative income tax baseline.\textsuperscript{19} That evaluation illustrates that the governing principle is straightforward: a deduction for an insurance

\textsuperscript{13} See Moline Props., Inc. v. Comm'r, 319 U.S. 436, 438-39 (1943); infra note 77 and accompanying text.

\textsuperscript{14} See infra Part II.B. The consolidated return regulations expressly require a separate entity treatment for direct insurance transactions between group members and an insurance company member. Treas. Reg. § 1.1502-13(e)(2)(ii)(A) (2018).

\textsuperscript{15} In general, the regulation of insurance companies is reserved to the states. McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (2012); see Patricia A. McCoy, Systemic Risk Oversight and the Shifting Balance of State and Federal Authority over Insurance, 5 U.C. IRVINE L. REV. 1389, 1393-400 (2015).

\textsuperscript{16} See Elizabeth F. Brown, Will the Federal Insurance Office Improve Insurance Regulation?, 81 U. CIN. L. REV. 551, 560 (2012) ("Determining whether this new product qualifies as insurance in all fifty states is not an easy process because no clear, universally accepted definition for insurance exists. Several states do not even try to define insurance within their statutes.").

\textsuperscript{17} See infra Part II.B; see also CLE Materials, Current Developments in Captive Insurance Companies, ABA Tax Section Meeting Panel (Sept. 2017), at slide 3 (on file with author) ("A captive insurance company is a bona fide licensed insurance or reinsurance company . . . .").

\textsuperscript{18} See infra Parts II-IV.

\textsuperscript{19} See infra Part III.A.
premium should not be allowed until there is a decline in value. The presence of related parties or various timing certainties alters the likelihood that the coverage purchased through captive structures consists of annual, discrete contracts whose value declines during each formal insurance term. Because of the difficulty in implementing the ideal solution—economic valuations that take into account various probabilities and relationships—this Article proposes three bright-line rule categories that could be used to separate deductible from nondeductible property insurance premiums.

Part II provides an overview of the current tax treatment of property insurance premiums and companies. Part II also presents an account of the litigation specific to defining insurance for tax purposes, including the IRS efforts to limit abusive conversions of savings into insurance premiums. Part III begins with a discussion of the normative definition of income, then uses a series of examples, culminating with captive insurance examples, to anchor the analysis of insurance premium deductibility to income tax principles. Part IV draws on the analysis of the examples to suggest potential bright-line reforms; it also briefly considers the extent to which legislative action would be required.

II. CURRENT TAX LAW FOR PROPERTY AND CASUALTY INSURANCE

This Part begins with background information regarding the tax treatment of property insurance, including a discussion of not only the current positive law governing the tax treatment of property insurance premium payments but also the tax treatment of property insurance companies. This Part then turns to the tax litigation over captive insurance structures.

A. Overview of Property and Casualty Insurance Tax Rules

1. Premium Deductibility for Business Coverage

When a taxpayer transfers money into a typical savings account, the taxpayer does not get a deduction because the taxpayer retains full control over the account, even if the money will be used to pay a deductible expense. In addition, the owner of the account will pay taxes

20. See infra Part III.A.
21. See infra Part III.B–C.
22. See infra Part IV.
23. See infra Part II.A.
24. See infra Part II.B.
on any interest earned on the account, even if the owner does not withdraw the interest. The bank is an intermediary holding the deposit as the agent of the account owner; the deposit is not a payment to the bank that could give rise to a deduction. The tax treatment for the purchase of an investment asset is generally similar: if a taxpayer buys corporate stock, the cost of the stock is not deductible and any dividend payments will be taxed to the owner of the stock. Changes in value to the underlying share are, however, generally not brought into the tax system (whether as income or as a deduction) until the taxpayer sells, exchanges, or otherwise experiences a realization event as to the investment.

In contrast to the treatment of savings and other investments, insurance premiums incurred to protect business and investment assets have been deductible since the question first arose under the income tax. The Internal Revenue Code ("Code") does not, however, contain a specific Code section regarding premium deductions, as it does for interest and tax payments. Instead, business and investment-related property insurance payments are viewed as "ordinary and necessary expenses," whose deductibility is authorized by general business and investment provisions. Department of the Treasury ("Treasury") regulations specify that business expenses include "insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business." As a result, if a business pays $10,000 for one year's worth


27. See Taylor, supra note 8, at 888 (noting that the Treasury expressly permitted deductions of business-related insurance premiums since at least 1919). Individuals who purchase insurance coverage for personal assets may not deduct their premiums. I.R.C. § 262(a). This Article focuses on property insurance and does not address life or health insurance, although some aspects of life insurance are raised by way of analogy. See infra note 208.

28. See I.R.C. §§ 163–164. Premiums paid by businesses for life insurance contracts are subject to specific limitation rules. Id. § 264; see also infra note 208.

29. See I.R.C. §§ 162(a), 212; Taylor, supra note 8, at 888.

30. Treas. Reg. § 1.162–1(a). The deduction reduces the ordinary income of the business. There is no specific parallel provision in the section 212 Treasury regulations, but the "ordinary and necessary expenses" language is the same in both statutes. See I.R.C. §§ 162(a), 212. Thus, taxpayers paying premiums on insurance for investment property also receive a deduction, but it will be a miscellaneous itemized deduction, which reduces its value. Treas. Reg. § 1.67–1T(a). For taxable years beginning after December 31, 2017, and before January 1, 2026, the value of a miscellaneous itemized deduction drops to zero because taxpayers are not permitted any such
of casualty insurance on its assets, the business will be able to take a deduction for the premium.

Taxpayers may be tempted to accelerate deductions by paying in advance for property insurance, but regulations limit taxpayers' ability to use timing mismatches between payment and coverage to their advantage. If a taxpayer purchases coverage that lasts longer than twelve months (or pays for twelve months of coverage that occurs too far into the future), the taxpayer creates an intangible asset, whose cost is not immediately deductible. The existence of a prepayment intangible is determined by looking not just at the formal contract terms but also at the economic substance, including whether the contract makes financial sense if it lasts only twelve months. If a prepayment intangible is created, the taxpayer does not lose the premium deduction, but instead of being able to deduct the entire premium at once, the taxpayer must spread out, or amortize, the deduction over the period of insurance coverage. For example, if the taxpayer spends $20,000 to...
purchase two years’ worth of business casualty insurance, the taxpayer will be permitted to deduct $10,000 each year for two years.36 These rules are relatively straightforward, but one key element is missing from the Code and regulations: a definition of “insurance.” As has already been alluded to in the Part I,37 this omission is at the heart of taxpayer attempts to convert nondeductible investment costs into deductible insurance premiums.38 Definitions that rely on risk are, however, inherently problematic because savings and other investments are also used as risk-management tools.39 The “rainy-day” savings account is the simple example; more complex risk-management tools include swaps and other derivatives. The proper taxation of derivatives remains a problem for the tax system,40 but the taxpayer’s upfront

policy acquisition costs incurred by an insurance company are, however, subject to section 197. Id. § 197(f)(5); see also id. § 848 (providing rules for the “[c]apitalization of certain policy acquisition expenses”); H.R. 1, 115th Cong. § 13519 (amending I.R.C. § 848(c) to extend the amortization period and change the net premium percentages used to calculate the amount to be capitalized). Instead, the prepayment is recovered over the “useful life” of the contract. Treas. Reg. § 1.167(a)-3. See I.R.C. § 167. The Code section 167 regulations do not specifically address prepayment intangibles, but by analogy to other regulatory provisions, the prepayment should be amortized ratably over the coverage period. See Treas. Reg. § 1.167(a)-14(c).

37. See supra notes 11-17 and accompanying text.
38. If a “premium” is recharacterized and is nondeductible and the parties are related corporations, the tax treatment is governed by corporate tax law. The IRS has asserted that the “premiums” should be treated as dividends, to the extent of earnings and profits, from the “insured” to the parent corporation followed by a contribution of capital from the parent to the ersatz insurance subsidiary. Rev. Rul. 77-316, 1977-2 C.B. 53, 54-55. Captive insurance is also used in estate planning strategies. For example, the assets of a family business owned by a married couple could be insured by a captive owned by their child. The temptation would be to move cash out of each parent’s estate by paying excessive premiums to the child’s captive insurance company. See S. REP. NO. 114-16, at 2 (2015) (“[T]here may be a need to address abuse of captive insurance companies for estate planning purposes.”); STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., JCX-144-15, TECHNICAL EXPLANATION OF THE PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015, HOUSE AMENDMENT #2 TO THE SENATE AMENDMENT TO H.R. 2029 at 201 n.657 (Rules Committee Print 114-40) (2015); Jay Adkisson, Congress Makes 831(b) Captives Much Better and Deals with (Some) Abuses in 2015 Appropriations Bill, FORBES (Dec. 19, 2015, 10:01 PM), https://www.forbes.com/sites/jayadkisson/2015/12/19/congress-makes-831b-captives-much-better-and-deals-with-some-abuses-in-2015-appropriations-bill/4/#6378e99e6a49. Legislation enacted in 2015 attempts to limit the extent to which captives used in such strategies can obtain income tax benefits available to small captives. I.R.C. § 831(b) (Supp. III 2016); Protecting Americans from Tax Hikes Act of 2015, 2015 Pub. L. 114-113, div. Q, § 333, 129 Stat. 2242, 3106-08. The use of captives in estate planning strategies is outside the scope of this Article.
40. The taxation of investment products is highly complex and itself the subject of multiple academic critiques and suggestions for reform. See, e.g., Alan L. Feld, When Fungible Portfolio Assets Meet: A Problem of Tax Recognition, 44 TAX L. W. 409 passim (1991); David Hasen,
investment in an option, swap, or similar investment asset does not generate an immediate deduction. The amount of money invested in the derivatives market is enormous. If even a small fraction of these transactions are shoehorned into something that qualifies for the tax benefits associated with insurance, the result will be a major loss of government revenue and a degradation of the tax system.

This Article advocates moving away from risk and toward more fundamental income tax principles in determining deductibility for insurance premiums. As will be discussed below, the IRS's initial "economic family" approach can be viewed as an attempt to look to income tax principles, but that effort quickly ran up against other obstacles. The IRS's current approach relies on risk—whether in direct terms (by looking at risk shifting and risk distribution), or in indirect terms (by comparing the scrutinized contract to commercial insurance or to other investment contracts).

2. Receipt of Insurance Proceeds

If insurance coverage is triggered and the insured receives insurance proceeds, the tax consequences to the insured depend on the nature of the asset covered by the contract. The insurance payout may make the taxpayer whole in an economic sense, yet the taxpayer may still have a tax loss (or even a tax gain). For example, consider a business that owns a building worth $200,000 that is insured for


44. See infra Parts III-IV.

45. See infra Part II.B.1.

46. This Article focuses on insurance covering the property of the insured and, to a lesser extent, harms to the insured’s business value. Insurance contracts are also available that cover the cost of harm done by the insured to others—for example, malpractice insurance and some features of car insurance. In such cases, the insurance proceeds are typically paid directly to the harmed party, which benefits the insured because it relieves the insured of a potential out-of-pocket cost. The tax treatment of malpractice or similar harm-to-others insurance is beyond the scope of this Article. For a discussion of this issue, see Jeffrey H. Kahn, Justifying the Exclusion of Insurance, 125 TAX NOTES 1216, 1216-18 (2009).
$200,000; it purchased the building in an earlier year for $300,000 and has deducted $50,000 of depreciation. If the building is destroyed in a fire, and the business receives $200,000 of insurance proceeds, the business would not pay tax on the proceeds and would be entitled to an additional $50,000 tax deduction, computed as the excess of (a) the original cost as reduced by depreciation over (b) the insurance payment.47 If the insurance coverage is lower (or the taxpayer lacks insurance), the amount of the tax loss will be commensurately higher. As a result, the tax system itself provides mitigation against risk of loss.48

The loss deduction is governed by a different provision than that relating to the deductibility of the original premium.49 Thus, the previously deducted premium payment and the receipt of insurance proceeds for a covered event are treated as two separate transactions under current tax law.

If a taxpayer withdraws cash from a savings account to pay for repair or replacement costs, such proceeds do not reduce the loss deduction because they will not be treated as reimbursements from an outside source.50 The withdrawal will also not be taxable, so long as the savings account is a standard, non-tax-preferred vehicle. Thus, if in the prior example, the taxpayer was uninsured and used $200,000 from savings to replace the destroyed building, the loss deduction would be $250,000 ($300,000 original cost less the depreciation already taken). If

47. See Treas. Reg. § 1.165–7(b)(1) (2018). If the event does not completely destroy the business or investment property, then the tax loss will be limited to the lesser of the adjusted basis or the unreimbursed decline in value. See id. A similar rule applies to theft losses. See Treas. Reg. § 1.165–8(c). A tax gain results if the original cost, after adjustment for depreciation (known as "adjusted basis" in tax jargon, I.R.C. § 1016 (2012)), is lower than the amount paid out under the insurance contract. If in the main text example, the business had instead purchased the building for $150,000 and taken $50,000 of depreciation deductions, the business would have a $100,000 tax gain ($200,000 of insurance proceeds minus $100,000 ($150,000 original cost minus the $50,000 depreciation deductions)). If a tax gain results from proceeds received for an involuntary conversion of the property, the taxpayer may elect to defer paying taxes on the gain, but only if the taxpayer purchases qualified replacement property within a certain time period (usually two years). See I.R.C. § 1033.


49. Compare I.R.C. § 165(a), with id. § 162(a).

the taxpayer liquidated an investment in order to raise the cash, that transaction would be treated as a taxable sale of the investment. For example, if, instead of withdrawing cash from a savings account, the taxpayer sold stock that he had purchased for $50,000 for $200,000, he would have a tax gain of $150,000 from the sale of the investment, which would be offset by the $250,000 loss from the building. If an "insurance" structure is re-characterized as an investment, payouts received from the ersatz insurance company will not be treated as reimbursements from an outside source that reduces the loss from any casualty event.

3. Insurance Company Taxation

Insurance companies that abide by various complex rules have an overall better tax treatment than standard taxable corporations, although legislation enacted in 2017 is likely to reduce some of the disparity. To put the benefit in extremely general terms, insurance companies are able to take deductions for their reserves. In contrast, non-insurance

51. See I.R.C. §§ 1001, 1222, 1231.
52. See Rev. Rul. 77-316, 1977-2 C.B. 53, 53-56; see also infra notes 187-89 (discussing when losses are sustained). If the payment is characterized as non-insurance and the parties are related corporations, the tax treatment is governed by corporate tax law. The IRS has asserted that any "insurance" proceeds should be treated as dividends paid, to the extent of earnings and profits, from the "insurer" subsidiary to the parent corporation followed by a contribution of capital from the parent to the "insureds." See id.
54. The computation of the deductions for a property insurance company are complex and provide for a substantial, but not 100%, deduction of loss reserves. See I.R.C. § 832(b)-(c); H.R. 1, 115th Cong. § 13515 (2017) (modifying proration rule of I.R.C. § 832(b)(5) to make it less generous). The technical details of the income tax treatment of insurance company reserves are beyond the scope of this Article and differ as between life insurance and casualty insurance. See David S. Miller, *Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace*, 55 Tax Law 481, 487-504 (2002). Compare I.R.C. §§ 801, 803-808, 810-812, 814-818 (discussing life insurance), with id. §§ 831–835 (discussing tax on other insurance). Companies that provide reinsurance (that is, insurance for insurance companies) are subject to a further set of tax rules. See id. § 848(d)(4); Prop. Treas. Reg. § 1.1297-4, 80 Fed. Reg. 22954, 22954-56 (Apr. 24, 2015). The 2017 tax legislation added a new I.R.C. § 59A, which applies a minimum tax on "base erosion payments." H.R. 1, 115th Cong. § 14401; see also Wells, supra note 1 passim (discussing BEAT); infra note 66 (same). Code section 59A specifically provides that reinsurance payments made to "a foreign person which is a related party of the taxpayer" constitute base erosion payments. Pub. L. No. 115-97, sec. 14401, § 59A(d).

The topic of reinsurance, including reinsurance captives or the use of captives to access
corporations that set up internal reserves for dealing with future risks are not able to deduct money set aside in those reserves; instead, they are treated as having merely moved money from one pocket to another.\textsuperscript{55} Certain types of insurance companies are eligible for tax benefits that are even more expansive.\textsuperscript{56} For example, small, non-life insurance companies are taxed only on their "taxable investment income."\textsuperscript{57}

The presence of this incentive has triggered a wave of "micro" captives.\textsuperscript{58} In 2015, when Congress increased the number of small companies eligible for this provision,\textsuperscript{59} Congress also enacted a new requirement that the small insurance company meet ownership diversification rules.\textsuperscript{60} This requirement was added specifically to limit the use of captive subsidiaries in estate tax planning.\textsuperscript{61} Under one of two diversification tests, "no more than 20 percent of the net written premiums" may be "attributable to any one policyholder."\textsuperscript{62}

reinsurance markets, is also beyond the scope of this Article. See Aviva Abramovsky, Reinsurance: The Silent Regulator?, 15 CONN. INS. L.J. 345 passim (2009); Daniel Schwarz, The Risks of Shadow Insurance, 50 GA. L. REV. 163, 179-204 (2015) (discussing risk introduced through use of reinsurers, including particularly captive reinsurers).


56. In addition to the benefit afforded small, non-life insurance companies described in the main text, some insurance companies qualify for tax-exempt status. See I.R.C. § 501(c)(12)(A), (15), (23)-(27), (29), (m)-(n).

57. Id. § 831(b)(1).


61. See supra note 38.

62. I.R.C. § 831(b)(2)(D)(i)(I) (Supp. III 2016). "Diversification" is something of a misnomer as the statute is not really aimed at risk diversification. This can be seen more clearly by taking a brief look at the alternate "diversification" test, which is more obviously aimed at preventing the estate planning strategy discussed supra note 38. It works by limiting the gap between the ownership stake in the insurance company and that in the covered assets. See I.R.C. § 831(b)(2)(B)(ii)(II) (Supp. III 2016). The alternate test imposes a restriction only if the captive is owned by the spouse or lineal descendant of the person whose interests or assets the captive insures. See id. § 831(b)(2)(B)(ii)(I)–(II) (Supp. III 2016). For example, a micro-captive 100% owned by a
purpose of this diversification test, the legislation requires that policyholders are counted by treating certain related policyholders as a single policyholder. These added tests signify a growing awareness regarding tax reduction schemes involving captives and perhaps signal a willingness on the part of Congress to recognize the role of related parties play in propagating such techniques.

Insurance companies are often located outside the United States, including in tax havens, although U.S. law may reduce the tax benefits of selecting such a location. A substantial number of insurance

son that insures property 100% owned by the son's parent, would not meet this statutory test, but if the son owns 97.9% of the insured property and his parent owns the other 2.1%, the arrangement would pass the alternate diversification test. See id. § 831(b)(2)(B)(i)(IV) (Supp. III 2016); see also STAFF OF JOINT COMM. ON TAXATION, supra note 38, at 201-02 (discussing the test and providing an additional example). The statute is not clearly worded, but because either diversification test can be met, it appears that if the captive owner and the owner(s) of the insured interests or assets are unrelated, the diversification requirement will automatically be satisfied. Thus, a micro-captive 100% owned by individual A whose only policyholder is individual B, unrelated to A, meets the diversification test; it fails the first statutory test, but because A and B are unrelated, it passes the alternate test. See 831(b) Diversification Requirements Far Less Daunting than They Seem, CIC SERV. (Jan. 21, 2016), http://captivatingthinking.com/831b-diversification-requirements-far-less-daunting-than-they-seem. The IRS has placed abusive micro-captives on its "Dirty Dozen" list of tax scams. I.R.S. News Release IR–2018–62 (Mar. 19, 2018); I.R.S. News Release IR–2017–31 (Feb. 14, 2017); I.R.S. News Release IR–2016–25 (Feb. 16, 2016). This Article focuses on captives used in tax avoidance techniques and not on their use in fraudulent scams, though the line between tax avoidance and tax evasion is not clear and drawing such a line may not necessarily be helpful. See, e.g., Allison Christians, Avoidance, Evasion, and Taxpayer Morality, 44 WASH. U. J.L. & Pol’y 39, 41-52 (2014).

63. See I.R.C. § 831(b)(2)(C)(i)(II) (Supp. III 2016). The attribution rules used are I.R.C. §§ 267(b), 707(b), or the controlled group test. I.R.C. § 831(b)(2)(C)(iii)(II). For the controlled group test, Code section 1563(a) applies by cross-reference, except that instead of at least 80 percent, "more than 50 percent" is substituted. See I.R.C. § 1563(a)(2) (2012). These attribution rules do not apply to the alternate diversification test, discussed supra note 62, which looks only to the spouse and lineal descendants of the insured assets.

64. For a brief discussion about whether these diversification tests are likely to stymie the growth of micro-captives, see supra note 62 and accompanying text.


66. First, provisions known as "subpart F" contain specific rules targeting non-U.S. insurance companies. I.R.C. § 953(c) (2012) (styled "Subpart F" in I.R.C. § 953 (Supp. IV 2017)). For an overview of subpart F, see generally Lawrence Lokken, Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations, 7 FLA. TAX REV. 185 (2005). See also supra note 2 (discussion regarding 2017 tax legislation and I.R.C. § 965, which is within Subpart F). Second, an excise tax is imposed on gross premiums paid to non-U.S. insurance companies (and non-U.S. reinsurance companies in a cascade). I.R.C. § 4371. Third, the 2017 legislation added a minimum tax relating to base erosion payments. H.R. 1, 115th Cong. § 14401 (2017). "The term 'base erosion payment' means any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable." Id. sec.
companies located in tax havens may elect to be taxed the same as U.S. insurance corporations to avoid these constraints. Even for companies taxed under U.S. law, moving offshore may still provide them with a benefit in the form of access to less restrictive insurance regulations, such as lower reserve requirements. The IRS has argued that lax insurance regulation indicates an abusive captive arrangement. As will be discussed below, this argument has found little success in the courts to date.

This Article focuses on restricting the use of captive arrangements through limiting the deductibility of premiums, but even this brief overview regarding the treatment of insurance companies highlights that the rules governing insurance companies also need to be re-examined.

B. The Captive Insurance Conundrum

The deductibility of insurance premiums for business and investment property provides an incentive to create structures that are formally labeled as insurance, but are economically closer to long-term investments. As will be discussed in further detail in this Subpart, the

14401, § 59A(d)(1). Thus, a base erosion payment would include an insurance premium paid by a U.S. corporation to a related non-U.S. insurance corporation and the term “related” is defined broadly and includes, for example, “any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer or any 25-percent owner of the taxpayer.” Id. § 59A(g)(1)(B). The minimum tax applies, however, only to large corporations (those with average annual gross receipts over a three-year period of at least $500 million). Id. § 59A(a). For an overview of the new BEAT, see Wells, supra note 1. Finally, the 2017 tax legislation also modified the definition of passive income for purposes of the passive foreign investment company rules in such a way that foreign captive insurance companies are less likely to qualify for the active insurance business exception. H.R. 1, 115th Cong. § 15401 (to be codified at I.R.C. § 1297(b)(2)(B), (f)); see Kristen E. Hazel et al., Tax Reform Update: Insurance Provisions – Spotlight on Property & Casualty Insurers, McDermott Will & Emery (Jan. 10, 2018), https://www.mwe.com/en/thought-leadership/publications/2018/01/tax-reform-update-insurance-provisions-spotlight. For a general overview regarding passive foreign investment companies, see Monica Gianni, PFICs Gone Wild!, 29 Akron Tax J. 29 passim (2014).

67. See id. § 953(d) (discussing an election provision for a foreign corporation); Rent-A-Center, 142 T.C. at 4 n.6; F. Hale Stewart & Beckett G. Cantley, U.S. Captive Insurance Law 64 (2d ed. 2015) (“Because of the lack of tax benefit from the CFC regime from captive insurance, most taxpayers opt to be treated as a domestic corporation.”); CLE Materials, supra note 17, at slide 9 (estimating that for one risk-management company, Marsh LLC (www.marsh.com), 33% of its “off shore captives are treated as US corporations and actually pay taxes in the US”).


69. See infra Part II.B.3.
most obviously problematic captive structures are no longer viable, but more complex structures have developed in their place.\textsuperscript{70}

Before turning to these structures and their tax treatment, it should be noted that the creators of these more complex structures argue that captive subsidiaries serve important non-tax purposes, such as allowing businesses to gain coverage as to risks for which commercial insurance is not available or more costly.\textsuperscript{71} Of course, many individuals and businesses save for non-tax reasons, including risk mitigation, and do so through standard, taxable investments. That some businesses choose to accumulate savings through captive structures for non-federal tax reasons does not mean the federal tax benefits are justified. While this Article focuses on the narrower issue of premium deductibility as evaluated against normative income tax principles, it is worth asking (even if there is not space in this Article for answering) whether the tax benefits available to insurance companies are intended to incentivize and subsidize intermediation costs and whether a captive operating without high intermediation costs should be able to benefit from such provisions.\textsuperscript{72}

As indicated above, “insurance” is not defined in the Code or in Treasury regulations.\textsuperscript{73} As a result, the courts have played a large role in shaping its meaning and its application. While there is some variation in the case law, the courts generally address whether an insurance arrangement should get the tax benefits of insurance by breaking the analysis into two parts. First, the courts examine whether the

\textsuperscript{70} See infra Part II.B.1.

\textsuperscript{71} See STEWART & CANTLEY, supra note 67, at 68 (“No one was attempting to devise an elaborate tax evasion scheme. Instead, all were attempting to solve a serious business problem—the need to procure and maintain an affordable insurance policy.”); Anastopoulo, supra note 3, at 213 (noting the incentive to use captive insurance “when insurance cannot be purchased from commercial insurance companies for a business risk or insurance can be purchased but at a prohibitive cost”); Lynch et al., supra note 3, at 8 (“For over 50 years, large affiliated corporations have been forming captives (related parties) to cover the risks not usually included in their commercial policies. Often, such risks were either uninsurable or very costly to insure.”). As discussed in Part I.A.3, the deduction for premiums is not the only potential benefit available through captive structures. CLE materials from a recent ABA Tax Section panel on captive companies identified various tax efficiencies relating to the insurance captives themselves: (1) “Accelerated tax deductions for loss reserves”; (2) “831(B) election allows a small captive to pay no federal income tax on underwriting income”; (3) “No Federal Excise Tax from offshore domiciles”; and (4) “Not subject to state income tax.” CLE Materials, supra note 17, at slide 8. These same materials noted that for one risk-management company (Marsh, www.marsh.com), forty-eight percent of its U.S. captives “actually achieve tax efficient status.” Id. at slide 9.

\textsuperscript{72} For a brief discussion of the effects of the 2017 legislation on these incentives, see supra notes 53-54, 66.

\textsuperscript{73} See supra Part II.A.1.
arrangement is a sham. Captive arrangements—those that utilize a related party insurance company—have fared fairly well under this examination, primarily because of a line of cases that emphasizes separate corporate identity. Second, the courts examine whether the arrangement includes: (1) risk shifting; (2) risk distribution or risk pooling; (3) insurance risk; and (4) whether the structure is in line with "commonly accepted notions of insurance."

Because of the low threshold required to demonstrate that an arrangement is not a sham, the tax litigation primarily centers on the meaning of insurance; this Article also focuses on the four inquiries of the insurance definition. These inquiries are highly interrelated. Risk shifting examines the relationship between a particular insured and the insurance company; risk distribution examines the relationship between the insurance company and a pool of insureds. The requirement of "insurance risk" necessitates determining whether the contractual arrangement protects against an insurable loss rather than against general investment and business losses. Whether a transaction conforms to commonly accepted notions of insurance tests the contested

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74. See, e.g., Rent-A-Center, 142 T.C. at 11-13.
75. See, e.g., id.
76. See, e.g., id. at 13. This Article breaks the test into four criteria, but some analyses treat this as a three-part test with risk shifting and risk distribution as subparts of a single part. See CLE Materials, supra note 17, at slide 14.
77. This low threshold stems from Moline Properties, Inc. v. Commissioner and its progeny. 319 U.S. 436 (1943). The Supreme Court's decision in Moline Properties is brief, and the facts are straightforward. A corporation was created at the behest of a creditor of its sole shareholder. Id. at 437. Later, when the corporation sold land that it had held for some time, the corporation argued that the gain should be taxed to its shareholder rather than to itself. Id. at 437-38. Its main argument was that the shareholder had been "coerced" by the creditor into forming the corporation, and that the corporation had not undertaken many activities. Id. at 438-40. The Supreme Court did not permit the corporation to disregard its own existence. Id. at 440. In what has become known as the Moline Properties doctrine, the Court emphasized: "[I]n matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." Id. at 439. Moline Properties was a government win, but since then, it has limited the ability of government actors to look beyond corporate boundaries to the essence of the relationships among corporations and shareholder. To be sure, numerous Code and regulatory exceptions have operated over time to mitigate the full force of Moline Properties, but in the absence of a more specific provision, courts continue to adhere to the doctrine. See, e.g., Rent-A-Center, 142 T.C. at 13. For additional discussion of Moline Properties and captive insurance, see, for example, William B. Barker, Federal Income Taxation and Captive Insurance, 6 VA. TAX REV. 267, 288-93 (1986); Lynch et al., supra note 3, at 10-11; Stuart R. Singer, When the Internal Revenue Service Abuses the System: Captive Insurance Companies and the Delusion of the Economic Family, 10 VA. TAX REV. 113, 149-51 (1990).
structure and contract terms against an arm's length structure and contract terms.\(^2\)

The current judicial approach to defining insurance has its origins in a 1941 Supreme Court case, *Helvring v. Le Gierse*.\(^3\) The case involved a life insurance policy and an annuity held by the same individual, an eighty-year-old woman who would die within a month of purchasing both policies.\(^4\) *Le Gierse* expressly states that both risk shifting and risk distribution are essential for insurance.\(^5\) But it should not be forgotten that the case involved life insurance held by an individual, a type of insurance in which risk shifting is far more obvious, and risk distribution is driven by robust actuarial information. The case also states, "Congress used the word 'insurance' in its commonly accepted sense."\(^6\) But when one reads the opinion carefully, it appears that the Court uses this phrase as well as a statement regarding the necessity of insurance risk as a way to restate the need for both risk shifting and risk distribution.\(^7\) As a result, although *Le Gierse* contains the seeds of all four inquiries, its analysis is repetitive and conclusory.

Arguably, the outcome in *Le Gierse* did not turn on a particular definition of insurance. Instead, the decision may be better viewed as a fact-driven, substance-over-form conclusion: an eighty-year-old woman who bought both a life insurance policy and an annuity from the same insurance company for an aggregate premium exceeding the value of the expected payout—and who then promptly died—did not buy a life insurance policy for purposes of the gross estate determination.\(^8\) The

\(^2\) See infra Part II.B.4.


\(^4\) *Le Gierse*, 312 U.S. at 536.

\(^5\) Id. at 539 ("[T]hese elements of risk shifting and risk distributing are essential to a life insurance contract . . . ").

\(^6\) Id. at 540. The Court is referring to Congress's use of the word "insurance" in then Code section 302(g).

\(^7\) Id. at 540-41. Immediately following the use of the phrase "commonly accepted sense," the Court noted again that implicit in insurance is the concept of shifting risk to an insurance group. *Id.* at 540. Immediately before its determination that the contracts lacked insurance risk, the Court wrote, "[the] question is whether the transaction in suit in fact involved an 'insurance risk' as outlined above." *Id.*

\(^8\) *Id.* at 542. An annuity provides the annuitant with financial certainty in the case of a long-life; life insurance policies provide beneficiaries with financial protection in case of the death of the insured. *See* Charlene Davis Luke, *Beating the "Wrap": The Agency Effort to Control Wraparound Insurance Tax Shelters*, 25 VA. TAX REV. 129, 133-34, 138-39 (2005). The two risks involved are each other's opposite (long life vs. sudden death), and the policies purchased in *Le Gierse* were intended to cancel each other out. *Le Gierse*, 312 U.S. at 541.
opinion thus is one more tax case emphasizing that formalities do not necessarily control the outcome. The Court notes, for example, that "the mere presence of the customary provisions does not create risk," but it does not go further and provide clear rules that could be used to decide the status of complex structures and risks. The Subparts below discuss these four requirements in greater detail and also provide an overview of the administrative and court rulings on taxpayer attempts to convert savings into deductible insurance premiums.

1. Risk Shifting and the Economic Family Theory

Through an insurance contract, a person facing a risk of loss pays a specified sum of money (premium) to an insurer; in exchange, the insurer agrees that, if the covered loss transpires, the insurer will pay to the insured an amount specified in the contract to mitigate the loss. Thus, for the price of the certain premium, the risk of an uncertain, future economic loss is shifted, as limited by the contract terms, from the insured to the insurer.

In its first battles over captive insurance structures, the IRS focused primarily on risk shifting, but its analysis also included language regarding the lack of economic loss. In this respect, the IRS’s approach can be viewed as tied to the basic income tax principle that deductions should not be permitted if there is not an economic loss. The IRS’s argument was straightforward: payments made to an entity in the same economic family did not shift risk because the risk never left the economic family, as measured by the potential for loss to the group.

For simple structures, the IRS prevailed. For an example of a simple structure, consider a corporation, Corp. A, which creates a wholly owned...
insurance subsidiary, I-Sub Z. In turn, I-Sub Z provides insurance for only one insured, its parent, Corp. A. Imagine that Corp. A has a policy that provides for a $200,000 payment against a casualty event. If the event occurs, and I-Sub Z pays $200,000 to its parent, this would immediately cause a corresponding decline in the value of the insurance subsidiary—a decline borne solely by its sole owner (and sole insured), Corp. A. The risk of loss will not have been successfully shifted from Corp. A to the insurer.

The IRS began losing cases when it attempted to apply its economic family theory to structures where the insurance subsidiary provided insurance to multiple sibling entities or where the subsidiary insured multiple unrelated parties in addition to insuring its parent and/or sibling entities. The IRS maintained that the risk of loss was not shifted from the insured entities to the related insurance company because any payment made by the insurance captive upon the happening of a covered event would cause a corresponding loss of value inside a single "economic family."

In evaluating the situation of an insurance subsidiary providing coverage to its sibling subsidiaries, the courts held that each corporation had to be viewed as a separate person for tax purposes. As a result, because the insured sibling subsidiaries did not have an ownership stake in their sibling insurer subsidiary, payments made for losses covered by the contracts would technically not be offset by a reduction in the value of any of the insured subsidiaries’ assets. The parent holding company would still experience a reduction in the value of its assets—that is, the economic loss of one subsidiary would be met with a transfer from another subsidiary so that, overall, the parent would experience the economic loss. Even though the risk was not substantively shifted outside the group of related entities, courts took a formalistic approach and evaluated risk shifting by looking only to whether the contract moved the risk from the insured to the insurer. In 2002, the IRS issued a ruling that expressly treated as insurance a policy running between an


95. See Harper Grp., 96 T.C. at 57; AMERCO, 96 T.C. at 35-36, 41.

96. See Kidde Indus. v. United States, 40 Fed. Cl. 42, 55-56 (1997) (first citing Moline Props., Inc. v. Comm’r, 319 U.S. 436, 438-39 (1943) (discussed supra note 77); and then noting that while an economic approach represents an “excellent analytical framework,” “the tax laws . . . do not treat corporations as fictitious entities that can be ignored”); see also Humana Inc. v. Comm’r, 881 F.2d 247, 252-56 (6th Cir. 1989); Hosp. Corp. of Am. v. Comm’r, 74 T.C.M. (CCH) 1020, 1033-36 (1997).

97. See Kidde Indus., 40 Fed. Cl. at 55-56.
insurance subsidiary and its twelve insured sibling corporations. With that, the IRS conceded defeat on its economic family argument.98

The parent of the insurance subsidiary still could not deduct premiums under the sibling subsidiary guidance because, unlike in the case of a sibling subsidiary, the increase in value to the parent of a payment from the subsidiary would be matched by a decline in value to the parent of its equity stake in its subsidiary. Captive structures added unrelated insureds in an effort to argue for deductibility for the parent corporation of premiums paid to its insurance subsidiary. Taxpayers asserted that such structures yielded the required risk shifting99 because the pool of unrelated insureds not only distributed risk but also shifted at least some risk from the parent to the pool of unrelated insureds. This argument prevailed with the courts,100 and it was bolstered by the fact that the IRS had long treated mutual insurance premiums as deductible.101

In mutual insurance, the policyholders are also the equity owners of the insurer,102 which means that insurance payouts to a policyholder-owner will have at least some effect on the value of the policyholder-owner’s equity stake.103 Commercially available mutual insurance has become less common through the process of demutualization, particularly of life insurance companies.104 Notwithstanding the relative paucity of commercial mutual insurance today, the failure of the IRS to provide principles for distinguishing between abusive captive insurance

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99. In addition, taxpayers also argued that the presence of unrelated insureds acted to prevent manipulation of the terms and prices for the contract running between the parent and subsidiary. For a discussion of the "Commonly Accepted Notions of Insurance" prong, infra Part II.B.4.

100. Amerco, Inc. v. Comm'r, 979 F.2d 162, 167 (9th Cir. 1992) ("[W]hen the pool consists of a substantial amount of dollars, and risk, from those outside the parent and its affiliates, there is a true shift of the risk, even though the parent could suffer somewhat if the captive made a payment on account of an insured’s loss."); Harper Grp., 96 T.C. at 59 ("In our opinion, in the captive insurance company arena, given a sufficient number of unrelated insureds, risk can be transferred from an owner-insured to the captive insurer.").

101. Amerco, 979 F.2d at 167 ("[T]he Commissioner’s position that there is no insurance unless all effects of a possible risk of loss have been removed from the insured . . . takes no real account of mutual insurance companies.").


103. See Amerco, 979 F.2d at 167-68 (explaining that in mutual insurance, “policyholders suffer losses each time an amount is paid out of the pool, whether that amount is for their own insurance risk or someone else’s”).

arrangements and mutual insurance structures is problematic and contributed to their lack of success in the judicial system.\textsuperscript{105} Even though most premium payments for life insurance are nondeductible, the tax definition of insurance has its roots in life insurance and annuity case law, as discussed above.\textsuperscript{106} In 2002, the IRS provided a safe harbor for group mutual insurance. In the ruling, no single policyholder-owner represented more than fifteen percent of the insurance company, whether measured by stock ownership or by insured risk, suggesting that as few as seven businesses, all unrelated through stock ownership, could form a safe harbor insurance risk pool.\textsuperscript{107} The ruling did not explain why a safe harbor was appropriate in such a situation.

This group captive ruling does not, however, answer the question of how many unrelated insureds are required for a parent of a wholly owned subsidiary to obtain a deduction for its premiums. The IRS issued a ruling, also in 2002, holding that a parent company could deduct premiums made to its wholly owned captive insurance company if less than fifty percent of the premiums received and risks covered by the insurance subsidiary related to the parent and the remainder of its received premiums and covered risks were attributable to businesses unrelated to the parent.\textsuperscript{108} One court decision has gone even further. In Harper Group, only thirty percent of the insurance subsidiary’s policyholders were unrelated to it, yet the court held the presence of these unrelated taxpayers permitted deductions not just by the insurance company’s sibling corporation but also by its parent.\textsuperscript{109}

The presence of unrelated policyholders will be even less economically meaningful if the parent provides guarantees or otherwise reimburses the obligations of the subsidiary insurer. That is, loss does not shift from the parent to the insurance pool if the parent is effectively on the hook for payments from its subsidiary insurer to unrelated insureds. In its various safe harbor rulings, the IRS has assumed as a fact that the parent did not act as the guarantor of or otherwise fund the subsidiary insurer’s obligations.\textsuperscript{110} Courts have, however, been willing to

\begin{itemize}
  \item \textsuperscript{105} See Amerco, 979 F.2d at 166-68.
  \item \textsuperscript{106} See supra Part II.B.
  \item \textsuperscript{107} Rev. Rul. 2002-91, 2002-2 C.B. 991, 991. As few as 7, because 100 divided by 15 is 6.67.
  \item \textsuperscript{110} See Rev. Rul. 2005-40, 2005-2 C.B. 4, 4 (“There are no guarantees of any kind in favor of Y with respect to the agreement, nor are any of the ‘premiums’ paid by X to Y in turn loaned back to X. X has no obligation to pay Y additional premiums if X’s actual losses during any period of coverage exceed the ‘premiums’ paid by X. X will not be entitled to any refund of ‘premiums’ paid if X’s actual losses are lower than the ‘premiums’ paid during any period.”); Rev. Rul. 2002-90,
ignore parental guarantees, albeit in cases where the guarantees had not been triggered and the courts found that the insurers were not undercapitalized.111

2. Risk Distribution

Risk distribution results from the creation of pools of insureds facing similar, but independent, risks.112 Commercial insurers must exercise care when constructing insurance pools. Traditionally, the goal is to create a large enough pool so that the insurance company can predict, using actuarial data and models, the expected average loss each year for the pool even though the company would not be able to predict exactly which specific insureds will experience loss. The expected average loss for the pool is then used in setting a premium price that will cover expected losses and administrative costs, and possibly yield a profit for the intermediary.113 The creation of pools is easiest to conceptualize in the context of life insurance. An insurance company is able to determine, because of robust actuarial data regarding life expectancy and certain health conditions, the average death rate for a particular age cohort.114 If the insurance company is able to insure a large enough number of individuals in that cohort, the average actual loss in the pool will trend toward the forecasted actuarial average. This relationship among the size of the pool, the expected outcome, and

2002-2 C.B. 985, 984 ("There are no parental (or other related party) guarantees of any kind made in favor of S. S does not loan any funds to P or to the 12 operating subsidiaries."); Rev. Rul. 2002-89, 2002-2 C.B. 984, 984 (P does not guarantee S’s performance and S does not make any loans to P). The group insurance ruling has a parallel rule, but written to take into account the larger group of owners. Rev. Rul. 2002-91, 2002-2 C.B. 991 ("No Member has any obligation to pay GC additional premiums if that Member’s actual losses during any period of coverage exceed the premiums paid by that Member.").

111. See Securitas Holdings, Inc. v. Comm’r, T.C. Memo 2014–225 (10/29/14) at 20-22 (“Respondent argues that the presence of the parental guaranty mitigates risk shifting because of the theoretical possibility that SRI may have to pay in accordance with the guaranty. However . . . we have previously held that the existence of a parental guaranty by itself is not enough to justify disregarding the captive insurance arrangement . . . .[N]o amount was paid out under the guaranty.”); Rent-A-Center, Inc. v. Comm’r, 142 T.C. 1, 27 (2014) (“Here, the fact finder did not find inadequate capitalization. And the mere existence of a parental guaranty is not enough for us to disregard the captive insurer; we must look to the substance of that guaranty.”); see also Malone & Hyde, Inc. v. Comm’r, 62 F.3d 835, 842 (6th Cir. 1995) (“When the entire scheme involves either undercapitalization or indemnification of the primary insurer by the taxpayer claiming the deduction, or both, these facts alone disqualify the premium payments from being [deductible].”).

112. See Securitas Holdings, T.C. Memo 2014–225 at 25 (“The insurer achieves risk distribution when it pools a large enough collection of unrelated risks, these that are not generally affected by the same circumstance or event.”).

113. See KONREUTHER ET AL., supra note 91, at 13.

114. See id. at 62.
the actual outcome is commonly referred to as the law of large numbers. Multiple conditions can complicate the construction of a risk pool, and these are discussed in connection with the examples evaluated in Part III.

The IRS, in virtually all of its public and private rulings, uses a definition of risk distribution or pooling that emphasizes the law of large numbers and has at times attempted to argue that policies less amenable to being priced using this law are not insurance. The IRS has, for example, suggested the need to look to whether insured risks are homogenous (and thus more likely to be consistent with use of the law of large numbers) and uncorrelated (again, making it more likely that the law of large numbers is operative). State insurance regulators are concerned about the pricing of insurance policies, but their focus is generally on protecting individual consumers against predatory marketing practices and potential insurance company insolvencies by regulating various aspects of an insurance company’s business, including its maintenance of reserves. There is less need for direct consumer protection as to business-related insurance, particularly when

115. See id. at 20–22.
118. The McCarran-Ferguson Act of 1945 established the authority of states to regulate insurance after the Supreme Court held in United States v. South-Eastern Underwriters Association that the federal government had jurisdiction to regulate insurance through the Commerce Clause. See McCarran-Ferguson Act, 15 U.S.C. § 1011 (2012); United States v. South-Eastern Underwriters Ass’n, 322 U.S. 533, 556-62 (1944); see also Robert W. Klein, The Insurance Industry and Its Regulation: An Overview, in THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES 13, 33-34 (Martin F. Grace & Robert W. Klein eds., 2009). Over time, the federal government has increased its oversight of insurance, particularly in certain areas (health, for example). Although various proposals for expanding federal regulation have been made from time to time, state insurance regulators continue to have primary oversight, in the absence of a specific carve-out (e.g., the national flood insurance program). See Klein, supra, at 32-35. In response to the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act created a Federal Insurance Office within the Treasury Department, but its area of responsibilities are unrelated to the development to the state regulation of captive insurance. See Brown, supra note 16, at 580-85 (describing responsibilities of the Federal Insurance Office).
a business has the resources to create or invest in an insurance subsidiary. Although state insurance regulators are unlikely to assert authority over a corporation’s maintenance of rainy day, internal reserves, multiple states have enacted captive regulation, thereby implicitly asserting that captive structures are insurance arrangements.

The IRS appears to view the law of large numbers as an inherent and necessary quality of “real” insurance risk pools, whereas state regulators, in practice, view the law of large numbers as a common element in insurance arrangements, but not as an element that must be present in order for them to assert regulatory authority. Indeed, there is no uniform, state law definition of insurance, even outside of the tax area. It is, of course, possible for Congress or administrative agencies to create a tax-specific definition for a particular word, but in this area, the IRS has argued that there is a single, economic definition of insurance. If state (or foreign) insurance regulators have made a determination that a particular arrangement is subject to their oversight (even if their oversight is limited), it is understandable that courts are reluctant to find that the arrangement is not insurance. This Article attempts to resolve this quandary by bringing the deductibility of insurance premiums into a framework that begins with tax principles instead of with insurance risk concepts.

The IRS also argues that risk distribution requires more than the applicability of the law of large numbers; in its view, the large numbers

120. See Brown, supra note 16, at 567 (“[I]nsurance regulators tend to exclude self-insurance that arises when an individual or an entity sets aside funds or other assets to cover any future losses or damages, as beyond the scope of their regulatory powers. They do so on the grounds that ‘insurance’ is about risk sharing and self-insurance does not involve risk sharing, but instead involves risk retention.”).


122. See Brown, supra note 16, at 568-70. For example, to a state regulator, it would seem odd to argue, for example, that coverage for hurricane damage is not insurance because of the potential for correlated losses. Yet, an early IRS revenue ruling gave as one reason for denying payments into a flood protection exchange the danger of correlated losses. Rev. Rul. 60-275, 1960-2 C.B. 43, 45 (“[T]here is little likelihood that there could be a real sharing of the risks, because the occurrence of a major flood probably would affect all properties in a particular flood basin.”).

123. See Brown, supra note 16, at 560.

124. See supra notes 151-59 and accompanying text.

125. See Yotis, supra note 121, at 33.

126. See, e.g., Rent-A-Center, Inc. v. Comm’r, 142 T.C. 1, 13-14 (2014) (noting that the captive “met Bermuda’s minimum statutory requirements” and was subject to regulatory control in Bermuda); see also supra note 17 and accompanying text (referring to ABA Tax Section meeting regarding captive insurance arrangements).

127. See infra Part III.
must arise from the presence of multiple, separate insureds and not only from multiple assets held by the same insured. A corporation, for example, could have such a large operation that for certain risks it would be able to utilize the law of large numbers to predict accurately the average loss expected to occur to its operation. While the corporation could use this information to create internal reserves, it has not engaged in risk distribution unless it pools these risks with other insureds. The IRS has had success in arguing that pooling is a necessary element of risk distribution. For example, the Court of Federal Claims did not permit a parent to deduct the premiums it paid to a subsidiary insurance company even though the parent’s operations consisted of a large number of divisions that could approximate an insurance pool in terms of the ability to predict average loss.

The IRS has, however, been largely unsuccessful in arguing that a pool consisting of related corporate siblings is not a true insurance pool, and the IRS has conceded defeat in a revenue ruling on risk distribution and related sibling entities. In a 2005 Revenue Ruling, the IRS posited a corporation that provided courier services and encountered a “significant volume of independent, homogenous risks” relating to those services (thus, the ruling addressed risks similar to those involving the vehicles used by UPS or FedEx). In one of the ruling situations, the corporation owned twelve state law entities that were disregarded for federal tax purposes. Each of these disregarded entities purchased insurance from an unrelated insurance company, and these entities were the insurance company’s only clients. The ruling held that no risk distribution was present because there was only a single insured. A second situation in the ruling permitted insurance deductions when the same twelve, wholly owned entities elected to be taxed as separate entities. Because of the

131. In the absence of an election, the income and losses of a single-owner LLC are taxed to its owner, such an LLC is known as a disregarded entity. Treas. Reg. § 301.7701-3(b)(1)(ii) (as amended in 2017).
132. Rev. Rul. 2005-40, 2005-2 C.B. 4, 6. Risk shifting was not addressed because the insurance company was not a captive. Id.
133. Id.
presence of separate, if related, insureds, the ruling held that risk pooling was present in such a situation.\textsuperscript{134}

This ruling is particularly troubling because it highlights how the use of insurance structures to reduce taxes has moved beyond the use of captive insurance companies to include structures that mimic the tax benefits to be derived from such arrangements. An insurance company that has as its clients only subsidiaries related to each other (but not related to the insurance company) is not providing the type of intermediation services found in standard commercial insurance structures. Such an insurance company is instead similar to a captive insurance subsidiary because its fortunes are wholly dependent on those of a single corporate hydra. Such rent-a-captive arrangements attempt to provide the benefits of captive insurance without the form of a captive arrangement.\textsuperscript{135}

3. Insurance Risk

After having suffered defeat on its arguments relating to risk shifting and risk distribution, the IRS has recently turned to the definition of insurance risk in its battle against new types of insurance arrangements.\textsuperscript{136} For example, in a private letter ruling issued in February 2016, the IRS reiterated its position that "[i]nsurance risk requires a fortuitous event or hazard and not a mere timing or investment risk."\textsuperscript{137} As an example of a fortuitous event, the IRS suggested fire or accident insurance and cited Black's Law Dictionary for its definition: "A happening that, because it occurs only by chance or accident, the parties could not reasonably have foreseen."\textsuperscript{138} This approach is consistent with the Code's provision of a casualty loss deduction only for sudden, unexpected events.\textsuperscript{139}

\begin{references}
\textsuperscript{134} Id.
\textsuperscript{137} I.R.S. Priv. Ltr. Rul. 2016-09-008, 19 (Feb. 26, 2016); see also Rev. Rul. 2007-47, 2007-2 C.B. 127, 128 (July 23, 2007) ("[A]rrangements entered into to manage losses that are at least substantially certain to occur, or that are not the result of fortuitous events, do not constitute insurance.").
\textsuperscript{138} I.R.S. Priv. Ltr. Rul. 2016-09-008, 19 (Feb. 26, 2016) (quoting Fortuitous Event, BLACK'S LAW DICTIONARY 725 (9th ed. 2009)).
\textsuperscript{139} See, e.g., Rev. Rul. 63-232, 1963-2 C.B. 97, 97 (discussing that termite damage is not a
\end{references}
In the letter ruling, the IRS addressed a list of purported insurance contracts and ruled in most of them that business risk, not insurance risk, was at stake. For example, one of the items addressed in the private letter ruling was insurance to cover unanticipated regulatory changes that could be costly to the business. The ruling held that setting aside money for such a contingency did not represent an insurance risk but instead merely represented normal business-related risk management. An internal Chief Counsel Advice Memorandum issued in 2015 used a similar strategy and held that a contract failed to cover insurance risk. This memorandum addressed a carefully constructed policy relating to healthcare services. The policy was constructed in such a way so that the premiums equaled the present value of a loss that was virtually certain to occur at a specific, future date. The memorandum emphasized that the transferred risk was primarily investment risk—e.g., the risk that a present value calculation was wrong—rather than insurance risk.

Similar arguments about lack of insurance risk were made (unsuccessfully) by the government in a Tax Court case, R.V.I. Guaranty. This 2015 decision involved an arrangement in which the insured risk involved the possible decline in value to leased vehicles. The case did not involve a captive structure and illustrates how the technique of converting savings into premiums is not solely an issue of related-party interactions. In an example given by the Tax Court, a company in the business of leasing cars might expect that at the end of the lease term, a car’s value would be $10,000, but it could end up at a casualty because it is not sudden).

140. I.R.S. Priv. Ltr. Rul. 2016-09-008, 20-25 (Feb. 26, 2016). Other items that were deemed not insurance for tax purposes included “excess pollution liability,” “loss of a major customer,” and “tax liability” insurance. Id. at 21-23. Only a limited number of items passed muster as representing insurance risk: weather-related insurance and insurance for wrongful acts by officers or directors. Id. at 24.


142. Id. at 2-5.

143. Id. at 3, 6.


146. R.V.I. Guar. Co., 145 T.C. at 209-210. The facts involved reinsurance rather than direct insurance. Id. at 210-11. An insurance company based in the U.S. reinsured all of its risks with a related, Bermuda corporation—which was actually, in an inversion twist, acting as the U.S. corporation’s parent rather than its subsidiary. Id.
lower value, say $8500. \textsuperscript{147} The insurance at issue provided protection in the case of a lower-than-expected residual value. \textsuperscript{148} Again, to use the Tax Court’s numbers, the policy might provide a payment if the car was worth less than 90% of the expected residual value at the end of the lease term. Here, given the expected residual value is $10,000, if the car was actually worth only $8500 at the end of the lease term, the contract would pay the insured $500. \textsuperscript{149}

The Tax Court opinion suggests an epic battle of experts over whether residual value reimbursement constituted insurance risk or investment risk. One of the government’s experts analogized the residual value insurance to a put option by which a taxpayer could, for the option price, be assured of the ability to sell the underlying asset if it declined below a certain value. \textsuperscript{150} The government also tried to argue that only “pure risk” constituted insurance risk, with pure risk meaning the type of risk embodied in a fire insurance policy. \textsuperscript{151} Finally, the government also argued that since the time of insurance payments was always known—the end of the lease term—the contract did not involve an insurance risk. \textsuperscript{152} While not entirely clear from the Tax Court’s description of these facts, the government appears to have been pointing out that the timing certainty made it likely that the premiums simply reflected the present

\textsuperscript{147} Id. at 212.  
\textsuperscript{148} Id.  
\textsuperscript{149} Id.  
\textsuperscript{150} Id. at 236. To elaborate on the put analogy advanced by the IRS, imagine a taxpayer holds stock in a corporation and purchases a put on that stock. For the price of the put, the taxpayer now has the right but not the obligation to sell the underlying stock for a contractually agreed upon amount on or before a certain date (an American-style option). See Rev. Rul. 78-182, 1978-1 C.B. 265 passim; KEVIN M. KEYES, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS & TRANSACTIONS 12-4 to -5 (1997). If the value of the stock declines, the taxpayer will exercise the put and thereby limit its losses on the stock. The cost of the exercised put is incorporated into the tax consequences of selling the stock. I.R.C. § 1234(a)(1) (2012); Rev. Rul. 78-182, 1978-1 C.B. 265, 265-66. While the taxpayer holds the unexercised put, it is still treated as the owner of the stock and will be taxed on any dividends applicable to the record owner of that stock. (Of course, if the business is organized as a “C” corporation, a dividends received deduction would be available. I.R.C. § 243 (a)–(b).) The taxpayer is not able to take a deduction on mere transfer of the payment to the writer of the option. Treas. Reg. § 1.263(a)–4 (d)(2)(i)(C)(7) (2018). Although control over the cost has passed into another party’s hands, the transaction is not considered closed until the option is exercised or the option expires. If the taxpayer exercises the put, the cost of the put is incorporated into the calculation of tax gain or loss on the underlying stock. I.R.C. § 1234 (a)(1). If the put expires unexercised, the taxpayer will be able to obtain an investment loss deduction for an amount equal to the cost of the put. There are situations when other anti-abuse rules may supersede the general rule of Code section 1234. See, e.g., I.R.C. § 1092 (straddles). For a critique of the current tax rules applicable to options, see Hasen, supra note 40, at 797-805.  
\textsuperscript{151} R.V.I. Guar. Co., 145 T.C. at 222-23.  
\textsuperscript{152} Id.
value of the future expected loss.\footnote{Id at 221 (stating that government expert opined that the residual value insurance did not present a "‘timing risk,’ namely the uncertainty that arises under most insurance policies as to when a covered loss will occur"). In a 2007 Revenue Ruling, the IRS held that an arrangement was not insurance where a business estimated the present value of its future costs and purchased a contract using a "premium" equal to that present value for coverage that would pay at a future date for the costs, whose exact timing and amount may have been uncertain but whose future existence was "inevitable." Rev. Rul. 2007-47, 2007-2 C.B. 127, 127.} This feature indicates the taxpayer was using the insurance arrangement like a savings vehicle with a known rate of return—in other words, they had custom-tailored a guaranteed investment contract.

The Tax Court was quite dismissive of the government’s attempts to define insurance risk narrowly, going so far as to label the government’s arguments as "essentially metaphysical in nature" and even citing Aristotle.\footnote{Id at 243-44 (footnote omitted); see also Harper Grp. v. Comm'r, 96 T.C. 45, 57 (1991) (stating that "principles of Federal taxation rather than economic and risk management theories" control).} The Tax Court concluded that the government’s "efforts to split hairs . . . are philosophically interesting. But we do not think they carry much weight."\footnote{Id at 245.} Rather, the Tax Court looked to state regulatory recognition of the policies as insurance and also analogized the policies to other types of products long recognized as insurance, such as municipal bond insurance.\footnote{Id at 243-46.} The Tax Court emphasized that the analogy to a put option was misplaced because "[t]he courts have long held that a product can be ‘insurance’ even though competing products exist in the financial marketplace." The Tax Court also pointed to the state’s regulation of the contracts as evidence that they constituted insurance.\footnote{See Steven Miller, Tax Court Shoots Down IRS in Insurance Case, ALLIANTNATIONAL BLOG (Oct. 20, 2015), http://alliantnationalblog.com/tax-court-shoots-down-irs-in-insurance-case.} The opinion in \textit{R.V.I.} suggests that the IRS may not receive a sympathetic hearing in its efforts to limit the meaning of insurance risk.\footnote{Id at 245.}

4. Commonly Accepted Notions of Insurance

This final requirement may at first seem to be the one offering the IRS the most chance of litigation success because insurance arrangements that have tax reduction as a central purpose will almost by definition exhibit traits that fail to conform to standard commercial
insurance products. Indeed, courts have been amenable to looking at all the facts and circumstances to see if the insurer and insured are comporting themselves in a plausible facsimile of a commercial insurance arrangement. Thus, for example, courts will inquire into the levels of capitalization and the methods used to calculate the premiums paid. In its taxpayer friendly rulings, the IRS has specified as an assumed fact that the premium amount and similar contractual terms were consistent with an arm’s length arrangement.

Although courts generally express a willingness to look closely at the terms of the arrangement, this has not translated into government victories. The central difficulty is again the separate taxpayer personhood of each entity. Having concluded as a preliminary matter that a structure is not a sham, courts appear reluctant to take an approach that would seem to re-open that decision, at least in the absence of near fraud. As a result, this fourth inquiry tends to be little more than a restatement of any preliminary discussion regarding sham. For example, in a recent Tax Court case, parental guarantees did not trigger a determination that the insurance subsidiary was undercapitalized. In that same case, the parent actually paid the captive insurance subsidiary on behalf of the parent’s other subsidiaries (and siblings to the insurance subsidiary) and then sought reimbursement from them. Many of the “payments,” including payments on insurance policies, were handled through bookkeeping changes and netting rather than through actual fund transfers. In addition, the subsidiary insurance captive did not have any of its own employees; instead, all of its officers and directors were employees of the parent corporation. The insurance captive outsourced most of its work to third-party management companies, and it was located in Bermuda, where, as the dissent noted, regulatory oversight and reserve requirements are “modest.”

162. See, e.g., Rev. Rul. 2005-40, 2005-2 C.B. 4, 4 (“The amount of ‘premiums’ under the arrangement is determined at arm’s length according to customary insurance industry rating formulas.”).
164. See Avrahami, 149 T.C. No. 7 at 53-57 (2017).
166. Id. at 5-6, 29 & n.8.
167. Id. at 5-6.
168. Id.
169. Id. at 40-43 (Lauber, J., dissenting).
The IRS would, of course, prefer to limit premium deductions to payments on contracts that mirror the reserves, terms, and pricing found in commercial consumer products, but with state regulators and courts accepting of the non-tax purposes put forward for captive insurance, the IRS's efforts have gained little traction. State law regulators are clearly willing to accept as insurance many contracts where solid actuarial data is lacking and insurance companies engage in guesswork, possibly even motivated by various biases. Federal tax regulators are seeking to prevent taxpayers from deducting transfers into what are effectively savings accounts and avoiding current taxation on the investment returns earned on those accounts. State law regulators appear to be concerned primarily with whether reserves are reasonably sufficient and marketing reasonably fair, taking into account the sophistication of the insured parties. The concerns of the Treasury and the IRS are not those of the state regulators. Indeed, the federal tax reduction possibilities may make asserting authority over captive insurance more attractive to state regulators if they seek to curry favor with the businesses seeking to form captives, as more states enact captive regulations, states currently without such regulations may decide to add them in order to compete.

III. WHETHER AND WHEN PROPERTY INSURANCE PREMIUMS SHOULD BE DEDUCTIBLE

The preceding discussion explained that the IRS's attempt to rely on risk—whether directly through defining risk shifting and risk distribution or indirectly through comparing the features of insurance to other forms of investment—is not working. This Part emphasizes the need to start with tax principles instead of with insurance risk concepts. It begins with an overview of normative income principles, which all point to the requirement that deductions are allowed only for real economic loss. This Part next evaluates a series of insurance examples against that baseline. The examples include standard property insurance policies but also draw on the fact patterns and situations

170. See Yotis, supra note 121 passim; see also Kunreuther et al., supra note 91, at 30-31, 154.
171. See supra notes 118-21 and accompanying text.
173. See Yotis, supra note 121, at 33-34.
174. See infra Part III.A.
175. See infra Part III.B-C.
highlighted in the history of captive insurance litigation discussed in the previous Part.

A. Normative Income Tax

The Haig-Simons income definition is the most widely accepted formulation of normative taxable income. It defines income as equaling consumption plus (or minus) net changes in wealth.\(^{176}\) The definition requires, for example, that the substitution of one type of asset for another of equal value would not be a taxable event since no net change in wealth will have occurred as a result of this event. Instead, under a Haig-Simons approach, net changes in wealth value would be measured at the end of each tax period, with net increases taxed and net decreases deducted.\(^{177}\)

Providing deductions for declines in wealth requires a system for measuring such declines.\(^{178}\) Adoption of a mark-to-market system is one approach. Under such a system, valuation of all of a taxpayer’s assets would be undertaken at the end of each tax period, but such a system is

176. See Joseph M. Dodge, The Fair Tax: The Personal Realization Income Tax, 19 FLA. TAX REV. 522, 531-33 (2016). The formula derives primarily from HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938), with Robert M. Haig receiving credit as well for his article, Robert M. Haig, The Concept of Income—Economic and Legal Aspects, in THE FEDERAL INCOME TAX 7 (Robert M. Haig ed., 1921). See Dodge, supra, at 526 n.3. While the formula seems straightforward, a multitude of law review articles suggest otherwise. See, e.g., William D. Andrews, Personal Deductions in an Ideal Income Tax, 86 HARV. L. REV. 309, 320-25; Boris I. Bittker, A “Comprehensive Tax Base” as a Goal of Income Tax Reform, 80 HARV. L. REV. 925, 932, 934-50 (1967); Dodge, supra, at 529-33; Daniel Shaviro, The Forgotten Henry Simons, 41 FLA. ST. U. L. REV. 1, 25-33 (2013); Victor Thuronyi, The Concept of Income, 46 TAX L. REV. 45, 48-53 (1990). Briefly, its shortcomings include that the terms “wealth” and “consumption” are not defined; the time for measuring the net change in wealth is not specified; the method of valuing wealth and consumption is not specified; and which taxpayer’s income, wealth, and consumption is measured is not specified. See Bittker, supra, at 934-35; Shaviro, supra, at 25-29; Thuronyi, supra, at 49-50. This lack of detail may appear to reduce the definition to aphorism, but the definition, particularly when read along with the extensive commentary provided by Henry Simons and numerous authors, significantly clarifies the reach of an income tax. See STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 4 (1985); Charlene D. Luke, What Would Henry Simons Do?: Using an Ideal to Shape and Explain the Economic Substance Doctrine, 11 HOUS. BUS. & TAX L.J. 108, 127-46 (2011).

177. Conventionally, this would be one-year, but accuracy (if not administrability) could be improved with shorter measuring periods. The current system measures changes in value, but only at realization events and with reference to a baseline that may be years old—for example, the original cost of the asset (i.e., cost basis). See supra note 26 and accompanying text.

178. Under the Haig-Simons definition, personal consumption constitutes income that also needs to be taxed at the end of each tax period; instead of directly taxing personal consumption, the same result can be achieved through preventing wealth decreases relating to personal consumption from entering into the net wealth change computation. See Dodge, supra note 176, at 529-39.
widely regarded as impracticable for non-publicly traded assets.\textsuperscript{179} For measuring value decline in assets, Paul Samuelson has proposed a system of economic depreciation that measures economic decline by looking to the present value of the future income stream of the investment.\textsuperscript{180} As time passes, the expected future payoffs will grow smaller, resulting in a sinking fund pattern where decline in value for earlier years will be lower than that in later years.\textsuperscript{181} If the income stream increases with the passage of time, the taxpayer would have even smaller deductions in early years (and theoretically could even have additional income).\textsuperscript{182} As with mark-to-market valuation, practical implementation is difficult given the need to make accurate predictions regarding the present value of future income streams.\textsuperscript{183}

The imprecision in our current system necessitates various rules and standards to provide greater certainty but also to prevent strategies that exploit and expand on such imprecision. For example, imagine a taxpayer who has won an award at trial. At what point does the taxpayer have income? When the judgment is rendered? When the award is paid? When the award is upheld on appeal? When no Supreme Court action is possible? Our current system relies on basis, capitalization, cost recovery, and realization with the result that asset value changes are measured, but far more haphazardly than they would be using normative principles.\textsuperscript{184}

For example, under an approach that valued wealth at the end of each tax period, contingencies would affect valuation of income. Thus, a


\textsuperscript{180} Paul A. Samuelson, Tax Deductibility of Economic Depreciation to Insure Invariant Valuations, 72 J. POL. ECON. 604 passim (1964); see also Christopher H. Hanna, Some Observations on a Pure Income Tax System, 34 INT’L L. 125, 127 (2000). Samuelson depreciation can also be articulated as identifying the interest-like return or internal rate of return (“IRR”) from an investment and reducing the IRR by the statutory tax rate. Calvin H. Johnson, Measure Tax Expenditures by Internal Rate of Return, 139 TAX NOTES 273, 275-77, 279-83 (2013).


\textsuperscript{182} Samuelson, supra note 180, at 605-06; see also Frankovic, supra note 181, at 1379.

\textsuperscript{183} Hanna, supra note 180, at 129. On the superiority of Samuelson depreciation, see Hanna, supra note 180, at 127-29; Johnson, supra note 180, at 279-83; Theodore S. Sims, Environmental “Remediation” Expenses and a Natural Interpretation of the Capitalization Requirement, 47 NAT’L TAX J. 703, 704-05 (1994). Samuelson proved that economic depreciation is the only approach that will ensure that the tax bracket of the buyer does not influence the value of the investment. See Sims, supra, at 704 ("[A]Asset values are invariant to their holders’ tax rates ... if and only if asset depreciation is economic."). On the potential implementation of Samuelson depreciation using the IRR, see generally Johnson, supra note 180.

\textsuperscript{184} See, e.g., Glogower, supra note 179, at 114-25.
jury award that has an eighty percent chance of being overturned on appeal would result in a lower income inclusion in the year of the award than one having only a twenty percent chance of being overturned. To deal with contingencies, our current realization-based system generally engages in rough calculations tending to result in an all-or-nothing approach for the current year, with the possibility of future adjustments if the initial inclusion or deduction was wrong. For example, income received under a “claim of right” is taxed even if there is some chance it will have to be returned;\textsuperscript{185} any change that does occur is handled through later-year adjustments.\textsuperscript{186}

Similar rough calculations are necessary for determining deductions. Losses are deductible when “evidenced by closed and completed transactions, fixed by identifiable events, and ... actually sustained during the taxable year.”\textsuperscript{187} In order for a loss to be sustained, there must be no “reasonable prospect of recovery.”\textsuperscript{188} While such approaches may seem far from the Haig-Simons baseline, they still roughly implement the goal of taxing only net changes. Our current tax system is arguably not currently capable of implementing fine-tuned valuations of complex contingencies, so instead it requires that a loss be held open—not be allowed—until it is reasonably likely that the loss is permanent. The current system’s approach of denying a deduction for a decline in value until there is no longer a “reasonable prospect of recovery” represents a supportable, pragmatic accommodation.\textsuperscript{189}

The next two Subparts use a series of examples to explore whether, when, and to what extent various types of premium payments would result in an economic decline in value that would support a deduction, but they also suggest pragmatic accommodations that take into account the adoption of our current tax system of the realization requirement.

\textsuperscript{185.} See United States v. Lewis, 340 U.S. 590, 591-92 (1951); N. Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932). If the money is being held as a deposit or its use is restricted, then it will generally not be income until the restrictions lift or the deposit is forfeited. See, e.g., Comm’r v. Indianapolis Power & Light Co., 493 U.S. 203, 213-14 (1990).

\textsuperscript{186.} I.R.C. § 1341; Rev. Rul. 68-153, 1968-1 C.B. 371 passim; see also I.R.C. § 111 (discussing the concept of inclusion after earlier deduction for recovery of tax benefits).

\textsuperscript{187.} Treas. Reg. § 1.165–1(b) (2018).

\textsuperscript{188.} Id. § 1.165–1(d)(2)(i).

\textsuperscript{189.} Id. § 1.165–1. If it is reasonably certain that a portion of the loss will not be reimbursed, that portion is immediately deductible. Id. § 1.165–1 (d)(2). Thus, if an insurance contract requires a taxpayer to experience some minimum out-of-pocket cost—for example, through a co-payment or insurance deductible, that portion is a loss for tax purposes even though the contract still holds out some prospect of recovery. Id. § 1.165–1 (d)(2)(ii).
B. Examples: Unrelated Insureds and Insurer

This Subpart examines non-captive insurance arrangements. Before turning to the examples, a discussion regarding terminology and governing assumptions is necessary. With respect to terminology, this Subpart uses the term “insurance” and related terms for ease of reference and is not taking a position as to whether the arrangement under discussion would qualify as insurance under current law, tax or otherwise. Instead, this Subpart uses the term “insured” to refer to the person making the premium payment and enjoying the benefits of coverage, while “insurer” refers to the person that will be required to make a payment to the insured if the covered event occurs. Their arrangement is referred to as “insurance.”

The examples also are governed by some assumptions. First, for this Subpart, it should be assumed that the parties are unrelated. Second, each entity is treated as a separate tax person. Finally, this Subpart ignores issues of character; as a result, the Subpart does not address potential tax rate differences that could arise if the recovery of a premium payment occurs as a reduction to insurance proceeds instead of through a deduction.

1. Standard Casualty Insurance

Consider the purchase of a standard fire insurance contract. Sole proprietor A owns the building from which her business is run and takes out a one-year policy to protect against loss arising from fire. Proprietor A pays the premium all at once. For purposes of this first variation, assume that Proprietor A has no information she’s hiding from the insurance company regarding the probability of a fire and further assume that she will continue to take due care to avoid a fire after purchasing the policy (the problems of adverse selection and moral hazard are discussed in a later Subpart). She will not receive a premium refund if the covered event does not occur during the coverage term.

The insurance company will construct a pool of fire insurance contracts; in creating the pool, the insurance company will prefer that the risk faced by each insured will be similar enough that a statistical prediction using the law of large numbers can be made about the likely loss for the pool. At the same time, the company will prefer that the risks in the pool be uncorrelated—that is, that the risks are independent of

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190. Of course, the payor on an insurance contract is not necessarily the same person as the insured. This is another simplification for clarity in the examples.

191. See infra Part III.B.3.
each other so that the likelihood that all (or a substantial portion) of the contracts are triggered all at once is as low as possible (correlated and systemic risks are discussed in later Subparts\textsuperscript{192}).

The case for deductibility by Proprietor $A$ of her premium payment is fairly straightforward, although careful consideration of normative income tax principles indicates that the deduction should not be front-loaded, as it is under current law. Proprietor $A$ has transferred money to a third-party insurer over which she has no ownership or control, but in exchange, she receives value from the insurer in the form of the year-long insurance coverage. It is reasonable to assume the price paid for the contract is equivalent to the value of the coverage, so that there is no change to wealth through the mere act of paying the premium.\textsuperscript{193}

Although coverage for one day of coverage is obviously worth less than coverage for an entire 365 days, under a standard property insurance contract, coverage retains value until the close of the day on the last day of the coverage period, because the probability of the occurrence of the covered event will generally not fluctuate widely over the contract term. That is, if there is a five percent probability of a fire on Day 1 of the contract, there is likely also a five percent probability of a fire on Day 365 of the contract.

As a result, it is reasonable to assume that in a standard commercial contract, the value of the coverage is not increasing, with the result that any day-by-day economic depreciation calculation would be back-loaded to some extent.\textsuperscript{194} If the covered event does not occur and the sole proprietor has no ability to recover any payment from the insurance company or from other insureds in the pool, the end of the coverage term triggers any remaining decrease in the sole proprietorship's wealth. This is roughly the same outcome as under current law for annual property insurance premiums for business or investment assets—with the difference being that the Code treats the payments as an annual expense, deductible on the tax return for the year in which the payment takes place. With a short time horizon and low interest rates, the difference between immediate deduction on that year's tax return and deduction over a one-year contract term will be small.

\textsuperscript{192} See infra Part III.B.6–7.
\textsuperscript{193} See Phila. Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954) ("[T]he value of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal."); see also KUNREUTHER ET AL., supra note 91, at 8-10. Actual behavior may, of course, deviate from this assumption in many respects. See KUNREUTHER ET AL., supra note 91, at 3-10 (exploring ways in which both insureds and insurers may act that run contrary to economically rational behavior).
\textsuperscript{194} See supra notes 180-83 and accompanying text.
If the covered event occurs during the coverage period and a payment is made by the insurer to the insured, there would be a wealth increase. If the contract terminates at the same time as the payout, the premium (via the initial value of the contract) would be taken into account in measuring the resulting net increase in wealth.\textsuperscript{195} If the contract remains in force and the value of the coverage remains unchanged (e.g., initial insurance payout related to minor damage), then as before, coverage will continue to have at least some value up until the point the contract's term is at an end.\textsuperscript{196}

2. Standard Casualty with Renewal

Many commercial property insurance contracts are routinely renewed each year. As will be discussed later, the presence of related parties creates a situation where the timing of contract termination can be more easily manipulated.\textsuperscript{197} Thinking about renewals in the commercial context highlights the contrast between the related-party setting and non-related party contracts purchased in a standard commercial setting. One question raised is whether the fact of renewal precludes (or reduces) a deduction for a decrease in wealth over each annual coverage period. By staying with the same company, and on substantially the same terms, an argument could be made that the insured continues to benefit from premiums paid in prior years—that is, all or some portion of her premium may be traceable and may still be held inside the insurance company. Such an argument would, however, fail to take into account the fungibility of cash, the commingling of her premium with other premiums received by the insurance company, and the lack of right to any refund when the covered event did not occur. If the insured has no control over, or access to, her paid premium, currently or in the future, then the prior payment is no longer part of her wealth portfolio, and the end of the coverage term will trigger the remaining

\textsuperscript{195} For example, assume Proprietor A spends $1000 for a contract, which has an equivalent $1000 value up until the covered event occurs, when the insurance proceeds—say, $50,000—are paid. The net increase would be $49,000 ($50,000 new wealth position over $1000 prior wealth position).

\textsuperscript{196} As discussed above, under current law, property insurance proceeds are treated as payments for the involuntary conversion of the underlying property, which triggers gain or loss tied to the basis the taxpayer has in that property. See supra Part II.A.2. The type of covered property also affects character of any gain or loss. See supra Part II.A.2. As noted above, this Subpart does not address the problem of character differentials, and focuses on the net wealth changes of the insurance contract items. Changes to the value of the underlying property would, of course, also need to be determined before the taxpayer's final net change in wealth could be determined. See supra Part III.A.

\textsuperscript{197} See infra Part III.C.1–3.
decline in the value of the purchased coverage, as discussed in the prior example. A more plausible reason to deny deductibility of the entire amount at the end of the first year is that some portion of the premium was paid for de facto renewal privilege(s) rather than for insurance coverage and some value remains attached to such privilege(s). In theory, the value of such privilege(s) could be accounted for separately. More pragmatically, in a commercial insurance arrangement, even if there is some value associated with such de facto renewal privilege(s), the amount is likely minimal.

3. Standard Casualty, Accompanied by Adverse Selection, Moral Hazard, or Fraud

Two common situations may cause an insurance policy to be improperly priced from the insurer’s perspective: adverse selection and moral hazard. Adverse selection refers to the notion that individuals facing a higher risk of the covered event will be the ones most likely to purchase insurance.\textsuperscript{198} If the insurance company has accurate information about the covered risks, it will still be able to price the contracts appropriately (though it will be at the higher price necessary to cover the higher risk\textsuperscript{199}). On the other hand, if the insured is able to hide risk information from the insurance company, the contract price will not reflect the covered risk. Moral hazard refers to the problem of insureds taking less care because they know any loss will be reimbursed by insurance.\textsuperscript{200} Again, if the insurance company is able to forecast the extent of the problem or police the insured for various behaviors, then the contract will still be priced appropriately. If, however, the insured succeeds in taking less care than is accounted for by the insurance company, the contract price will not reflect the covered risk. At the extreme end of an insured’s behavior, the activity moves from lack of care into deliberate fraud—for example, the insured hires an arsonist.


\textsuperscript{199} If the price gets too high, consumers will be more hesitant to purchase the contracts, which may require even higher pricing as consumers drop out. At some point, the pool may enter a “death spiral.” See, e.g., Peter Siegelman, Adverse Selection in Insurance Markets: An Exaggerated Threat, 113 YALE L.J. 1223, 1254 (2004).

If the insured pays a premium that is priced too low because it fails to reflect adverse selection or moral hazard, there will still be a decrease in wealth by the end of the coverage period. (The premium will be purchasing a higher-than-paid-for value of insurance, which may alter the day-by-day economic recovery schedule.) Once the coverage ends, the value of the contract still completes its decrease to zero, and there will still be little reason to treat the insured as experiencing a continued investment consisting of past premiums.

The preceding analysis assumes garden variety adverse selection and moral hazard—failure to disclose risk or lack of care after purchasing the contract. If the insured’s behavior shades into deliberate fraud, taxpayer intent may change the analysis. For example, imagine that Proprietor A purchases fire insurance with the intention of burning down her property. If the time frame remains one year, then the conclusion that tax recovery of the premium occurs by the end of the contract term would not change (though there are good non-income tax related reasons to deny the recovery\footnote{\textit{\textsuperscript{201}}}).

Consider, however, if the sole proprietor acts with particular deviousness. She knows that the purchase of fire insurance followed shortly thereafter by a suspicious fire is a pattern that will likely lead to an investigation. Instead, she plans to purchase fire insurance, renew multiple times, and then burn down her own property in the fifth coverage year. In such a situation, the substance of the payments should be taken into account, so that instead of being viewed as purchases of annual insurance coverage (with a wealth decline at the end each year), she should be treated as constructing a (fraudulent) investment and each “premium” would be an investment in the future payout. The value of the investment would be annually measured, but it seems probable that the longer the scheme remains undetected, the more valuable the investment would become. As a result of the arson intent, there would not be five one-year contracts; instead, there would be a single five-year investment, paid for through installments. In such an arrangement, the taxpayer would likely experience value increases rather than value decreases. In the absence of an economic accrual system and in order to be consistent with the realization requirement, the “premiums” should only be recovered in the final year of the scheme through a reduction to the taxable amount of the payout\footnote{\textit{\textsuperscript{202}}}.

\footnote{\textit{\textsuperscript{201}}} See, e.g., I.R.C. \S 162 (c)(2) (2012) (encompassing denial of deduction for illegal payments); Rev. Rul. 82-74, 1982-1 C.B. 110 \textit{passim} (denying business deduction for amounts paid to arsonist).

\footnote{\textit{\textsuperscript{202}}} Though again, there are social policy reasons to limit the payout being offset by the
The arsonist example may seem unrelated to the problem of captive insurance. As will be discussed below, however, the presence of related parties allows for manipulation regarding the length of the contracts.\textsuperscript{203} In addition, the terms of an arrangement between unrelated parties may indicate that the transaction is in reality a long-term bet or investment contract rather than a series of short-term contracts.

4. Coverage with Certainty About Timing or Event

The preceding Subpart discussed the case of an arsonist with long-term planning skills. This Subpart contemplates situations where both the insured and insurance company have knowledge regarding some aspects of the coverage. Consider a contract where both the insured and the insurance company know that a fire will occur in Year 5, but neither party knows how severe the fire will be—that is, the fire could cause virtually no damage or could be so extensive that the entire building has to be razed. The insurance company agrees to cover the Year 5 event, but requires premiums to begin in Year 1, with annual payments thereafter. The insured will be hoping that the fire is large enough to allow recouping of the premium payments, while the insurance company would prefer a fire so small that its payout responsibility is lower than the premiums received.

While this may seem far-fetched, it is essentially the same type of contract that was at issue in the \textit{R. V.I.} case discussed above.\textsuperscript{204} Whether or not this is an insurance contract or some other financial contract is not particularly relevant to whether the insured experiences a net decline in value over each year equal to the amount of the annual premium. Since the bet does not close until Year 5, one way to view what is happening economically is that the “insured” is depositing collateral with the “insurance company” in order to guarantee that the insured (who is likely to be less well capitalized) will make good on her end of the bet. If one views the “premiums” as a cash deposit, then it is clear there is no decline in value (ignoring inflationary effects), and indeed there arguably should be deemed interest paid by the insurance company to the insured. If the contract is structured (as it arguably was in \textit{R. V.I.})\textsuperscript{205}

\begin{footnotes}
\footnotetext[201]{} premiums. \textit{See supra} note 201.
\footnotetext[203]{} \textit{See infra} Part III.C.2.
\footnotetext[205]{} \textit{See supra} notes 145-59 and accompanying text (discussing the government’s failed arguments).
\end{footnotes}
to provide a minimum return to the insured, this characterization (i.e., an interest-bearing cash deposit) is even more apt.\textsuperscript{206}

A similar analysis would apply if the scope of the covered event was known by both the insured and the insurer, but some uncertainty remains with respect to the timing of the event. For example, assume that the parties know that at some point over the next twenty years, a fire causing a known amount of damage will occur. The parties agree to maintain the arrangement until the earlier of twenty years or the occurrence of the fire. Through the price negotiated for annual “premiums,” the parties will place a wager regarding when the fire will occur. Once again, the payments could be characterized as economically equivalent to cash deposits that act as collateral securing the insured’s end of the wager. If the transaction were subject to the realization requirement, there would be no tax consequences until the bet is settled (although, depending on the facts and circumstances, it may be appropriate to deem an interest payment running from the insurance company to the insured). Whether or not a normative, economic accrual system would generate interim gains and losses would depend on the terms of the bet and on the prevailing market conditions. Certainly, if the arrangement’s expected returns are those typical of a low-risk savings account (again, as was the case in \textit{R. VI.} \textsuperscript{207}), there would not be economic declines associated with the annual “premiums.”

The prior example suggests that deductibility should be restricted if the arrangement covers events or losses that are virtually certain to occur for the business at some point. That this type of certainty could signify that the insured experiences lower or no annual declines in value may seem problematic in light of life insurance. After all, the essence of life insurance is the purchase of coverage for an event that is certain to occur, but whose timing is unknown, and life insurance is the quintessential example of insurance.\textsuperscript{208} This Article seeks to challenge

\textsuperscript{206} This is not the only possible characterization. As the IRS has noted, when the “premiums” are designed to equal the present value of an expected future cost, there should be no deduction and the arrangement “may instead be characterized as a deposit arrangement, a loan, a contribution to capital (to the extent of net value, if any), an option or indemnity contract, or otherwise, based on the substance of the arrangement between the parties.” Rev. Rul. 2007-47, 2007-2 C.B. 127, 129.

\textsuperscript{207} \textit{R. VI. Guar. Co.}, 145 T.C. at 236.

\textsuperscript{208} While this Article focuses on property insurance, understanding why commercial term life insurance produces annual declines in value (albeit generally non-deductible because of being personal consumption) is important to unraveling the inherent problems in captive arrangements. If a business purchases life insurance on a key employee and is the beneficiary on the policy then the annual premiums will be deductible if various hurdles aimed at preventing tax shelter transactions are cleared. See I.R.C. § 264 (e)(1); Beckett G. Cantley, \textit{Repeat as Necessary: Historical IRS Policy Weapons to Combat Conduit Captive Insurance Company Deductible Purchases of Life Insurance},
the assumption that the purchase of anything generally thought of as “insurance” should automatically lead to deductions for premiums in the business context. Consider, for example, an insurance company that offers life insurance to someone facing imminent death. The company will either charge so much that the arrangement is in substance a savings account for funeral and burial costs or the company will require a hedge—such as, for example, requiring the person to buy an annuity at the same time, as happened in *Le Gierse.* Because life insurance premiums are generally not deductible, there has been less concern regarding the extent to which the eventual certainty of the event should affect the tax characterization of the premiums.

For most term life insurance contracts, the ultimate certainty of death would not preclude annual deductions (if they were not personal consumption) because the real issue is whether there is certainty that the event will happen during the coverage period (whether that is one or multiple years). In the fire example above, the hypothetical specified that the parties would hold open the contract until the event happened. As will be explored in greater detail below, if related parties enter into an insurance arrangement, the relationship may, as a matter of substance, be the same as though the parties have agreed to continue the arrangement until a particular event occurs (and, of course, a business’s lifespan is not constrained in the same way as that of a natural person).

5. Unusual Risks

Some risks are unusual, and it may be difficult to find a commercial insurance provider to cover them. “Unusual” could mean that the risk is of low likelihood but high potential consequence or it could mean a risk that is relevant to a narrow swath of businesses. In either situation, two main reasons emerge for the difficulty in finding commercial coverage. First, the covered event may be so unusual that it is impossible to get beyond a guess regarding the statistical probability of the event occurring, and a commercial insurer may be unwilling take on that uncertainty. Second, constructing a risk pool would also be difficult. As already mentioned, the construction of a large risk pool limits the insurer’s exposure. The difficulty of obtaining commercial coverage for unusual risks is one of the principal non-tax reasons cited for the

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209. See supra notes 83-89 and accompanying text; see also Helvering v. Le Gierse, 312 U.S. 531, 532-33 (1941).
210. See supra Part III.C.
211. See supra Part II.B.2.
need for mutual arrangements, including captive structures.\textsuperscript{212} This Article suggests that discussions about whether such a contract is or is not “insurance” are unproductive when considering whether payments should be deductible.\textsuperscript{213} Instead, the inquiry should be a substantive examination into whether and when there has been a decline in wealth.

Imagine that Proprietor A has just read the novel \textit{The Fireman}, by Joe Hill, in which humans infected with the dragonscale spore spontaneously combust at unpredictable times, dramatically increasing the amount of property damage from fires.\textsuperscript{214} The proprietor decides she would like to purchase insurance against the highly improbable risk of fire-starting, human-infecting spores. Proprietor A is able to find someone willing to accept an annual payment in exchange for coverage for that year against damage arising from such a spore.\textsuperscript{215} Assume that there is no risk pool—only this single contract, insured, and insurer. Thus, it is not “insurance” at all in the standard sense of the word, and certainly not under the definition employed by the IRS, yet, in terms of the normative income tax, there is a decline in wealth over each year equal to the annual coverage payment for the reasons stated in the first example above.

Consider instead a case where the process for producing a particular chemical compound poses fire risks, but there is only one manufacturer of this chemical in the world, and the risk is known to be substantially different from that applicable to producing any other chemical compound. As a result, forming a risk pool is impossible, and any contract the manufacturer entered into to obtain coverage in case of a fire resulting from the production process would not meet the current definition of insurance used by the IRS. Whether and when there is a decline in value will, however, turn on the contract terms and the presence of some certainty about the likelihood of fire. For example, if each year the manufacturer must find a new counterparty and the contract with the prior counterparty expires without possibility of refund, there will be an annual decrease in wealth experienced by the manufacturer. Even if instead, it is certain that the fire will happen at some point within the lifespan of the business and the manufacturer finds a counterparty willing to enter into a bet as to either the precise time or the scope of the damage, then the analysis would be essentially

\begin{itemize}
\item \textsuperscript{212} See supra note 71 and accompanying text.
\item \textsuperscript{213} See supra Part III.A.
\item \textsuperscript{214} JOE HILL, THE FIREMAN 2, 29-30, 32-34 (2016).
\item \textsuperscript{215} Whether it would be ethical for the “insurer” to agree to such a contract is an issue beyond the scope of this Article.
\end{itemize}
the same as in the examples discussed above in Subpart 4. That is, if the realization requirement applied, the conclusion of each bet (whether over one year or multiple years) would trigger the tax consequences (with some possibility of imputed interest, depending on the arrangement). Under a normative accrual approach, any interim gains and losses would depend on the contract terms and on market conditions.

6. Correlated Risk

Certain types of property damage do not occur as isolated events. For example, if a hurricane makes landfall, it is likely to trigger a wave of property and flood insurance claims. Even though a commercial insurance provider may have a good ability to judge the probability and costs of a particular event, if such an event triggered all of the contract claims in the risk pool at the same time, the company might not be able to absorb such a large loss. Government may step in to provide or subsidize coverage, with flood insurance being the main example. If a private commercial market is available, the premiums may be quite high and coverage may be only partial. Lack of affordable coverage for a correlated risk is another reason frequently given to explain the need for captive insurance structures.

Putting to one side whether coverage for correlated risks (which may also be low probability risks) constitutes “insurance,” the question is again whether the payment of a premium for a correlated risk should be deductible over the coverage term. By now, the answer may seem rote: as the coverage value drops to zero over the term, there is a decrease. The problem is not the type of risk, but rather whether and when the bet between the parties changes value.

7. Non-Physical Harm and Decline in Value

Under the current Code, no casualty loss is generally permitted for mere declines in value, contrary to what would be required if mark-to-market valuation were used instead. In what is perhaps the most
famous case in this area, an individual living in the same neighborhood as O.J. Simpson during the events surrounding the murders of Nicole Brown Simpson and Ron Goldman claimed a casualty loss deduction by arguing that his property declined in value in the wake of the case’s notoriety.221 The argument failed, with the court holding that mere decline in value did not constitute a casualty loss.222 The case highlights the role the realization requirement plays in the casualty loss deduction context: a physical trauma to the property leading to a decline in value is treated as a realization event (or partial realization event), and the taxpayer’s basis (or portion) is recoverable as a deduction.223 As discussed above, the realization requirement is a practical accommodation; a normative income tax would not utilize such a feature but would instead measure economic changes in value for each tax period, and net declines in wealth, other than those relating to personal consumption, would trigger a deduction.224 But, in the presence of the realization requirement, if there has been only a decline in value and no realization event, generally no deduction is allowed in order to prevent acceleration of losses. This may seem harsh, but the individual could sell the investment or business property to recognize the loss and thereby obtain a deduction;225 with the transfer of ownership, the taxpayer gives up the possibility that the current decline in value is temporary and will be erased by a future value increase.

Our current system’s requirement that a casualty loss be sudden and involve more than a mere decline in value is thus related to the realization requirement (and to social policy, in the case of nonbusiness
or noninvestment casualty losses). To put it another way, under a normative valuation system, net declines in value occurring in business or investment property would generate deductions, whether the source of the decline were a sudden casualty event or a systemic market downturn. As discussed above, the IRS is attempting to import the casualty loss standard of suddenness and physical damage to determine whether coverage for a particular value decline is insurance or not. However, the better question to pose, again, is to ask whether and when there has been a measurable decline in value. At the same time, because the realization requirement is the rule in the current income tax system, care must be taken not to provide opportunities for taxpayers to accelerate losses but defer gains.

Imagine that Proprietor B is concerned that crime at some point in the future will erode the value of his entire business, including not just the value of his building, but also his business’s value as a going concern. Proprietor B would not be eligible for a casualty loss deduction if such a decline in value occurred, and in the absence of a sale or other realization event, would also not be eligible to take another type of business loss. Proprietor B wants to have some certainty, so he buys an insurance policy that will make a payment to him if certain objective benchmarks are reached that correlate with lower property values (e.g., an increase in certain types of crimes, an increase in the number of foreclosures in the business zip code, etc.). So long as the value of the coverage drops to zero by the end of each year, this type of coverage still supports annual deductions. If the counterparty is a commercial company unrelated to the proprietor, the value of the contract likely does drop to zero by the end of each year. It is a series of bets, with each year closing the bet, and triggering a decline in value to the insured in the amount of the “premium,” which did not generate any winnings.

227. See supra Part II.B.3.
228. Businesses currently have the option of abandoning property and obtaining an ordinary loss deduction that way. See Pilgrim’s Pride v. Comm’r, 779 F.3d 311, 314 (5th Cir. 2015). The current approach to abandonment loss is problematic, particularly because of the way it may be used to convert capital loss to ordinary loss. See Calvin H. Johnson, End Tax Subsidy from Abandonments and Swaps, 152 TAX NOTES 1171, 1171-72 (2016).
229. Such a contract may raise ethical issues that are beyond the scope of this Article.
230. Wagering losses are deductible only to the extent of wagering winnings, but that Code section has more to do with social policy and administrability of the Code than with whether a gambling loss represents a real decline in value. See I.R.C. § 165(d); I.R.S. Gen. Couns. Mem. AM2008-013 passim (Dec. 10, 2018) (explaining how I.R.C. § 165(d) is applied to a professional gambler and describing how this section of the Code relates to the rest of the Code using court cases and examples). The 2017 tax legislation added that wagering losses temporarily include wagering expenses. H.R. 1, 115th Cong. § 11050 (2017) (to be codified at I.R.C. § 165(d)). Of course, highly
The next Subpart turns to examples involving situations where insureds are related to the insurer, other insureds, or both. As will be highlighted, the presence of related parties and the control asserted by virtue of those relationships alters the likelihood that the coverage purchased through such structures consists of annual, discrete contracts that drop to a zero value by the end of each year. In the case of unrelated parties, if the bet does not in substance close until a future date, the need to limit the ability of taxpayers to accelerate losses (given the realization requirement) suggests that the tax consequences should not be determined until the bet closes.

C. Examples: Captive Arrangements

This Subpart considers examples in which there is relatedness between the insured and the insurer. As in the previous series, the focus is on the insureds and their ability to take deductions rather than on whether the insurer should gain access to the unique tax provisions applicable to insurance companies.

1. Parent as Only Insured of Subsidiary Insurer

As discussed in Part II, courts have agreed with the IRS and denied tax benefits to a simple captive structure where a parent is the only client of its wholly owned insurance subsidiary. The IRS argued that the insured parent failed to shift economic risk of loss to its insurance subsidiary because if the subsidiary made an insurance payment to its parent, the value of the parent's ownership stake in the subsidiary would decline in value by a comparable amount. This is correct but incomplete. There is also no net decrease in wealth because each annual premium paid to its subsidiary increases the value of the parent's ownership stake. In addition, the insurance coverage purchased by a parent from its own captive subsidiary is not going to result in a concomitant decline in value over the year, no matter how the contracts are formally drafted.

To see this, consider a Parent who pays $20,000 in Year 1 to its wholly owned captive insurance subsidiary in exchange for a one-year fire insurance contract. Assume that this price is comparable to the
amount the Parent would pay to a commercial insurer. There is no decrease in wealth since Parent will own a subsidiary that is $20,000 better off as a result. If the fire does not happen in Year 1, completion of the one-year contract does not signify a decrease in wealth as it does in the commercial context. With a commercial contract, there is a real loss by that point in time. As discussed above, the presence of multiple other unrelated insureds, the arm’s length relationship with the insurance company, and the lack of refund features ensure that the closing of each coverage term signals a drop in value of that year’s contract to zero. In contrast, when the Parent renews its contract with its wholly owned subsidiary and the Parent is the only client, the likelihood that the Parent’s own premiums will fund an eventual “insurance” payout (or some other benefit to the Parent) is 100%. An analogy may be helpful: imagine a casino in which there is only one slot machine and the owner of the machine is the only person ever allowed to put quarters into that machine. The owner will keep putting quarters into the slot machine until the owner hits the jackpot. Its previous quarters are not lost to the owner by virtue of putting them in the machine, even if the slot machine is identical to a commercial slot machine. The owner could simply open up the machine and take the quarters when it wished without waiting for the jackpot payout. Similarly, because the Parent controls the subsidiary, it can extract the value of what it has paid into the subsidiary by other means—such as by having the subsidiary use the money to pay for other types of costs to the benefit of the Parent.

The courts and the IRS are in agreement that such an arrangement is not insurance, but focusing on the lack of risk shifting and risk pools arguably puts too much emphasis on the symptoms of the larger problem, the lack of any net decrease in value to the insured.235 To be sure, the IRS’s economic family argument made a similar point but failed to gain acceptance in the courts for the reasons discussed above in Part II.B.

2. Sibling Subsidiaries

The IRS has largely conceded that a contract running from an insurance subsidiary to its sibling subsidiaries constitutes insurance. As discussed in Part II, this concession has been driven by the courts’ adherence to the separate entity status of each subsidiary.236 Under the courts’ approach, risk is effectively shifted from each insured subsidiary

235. The payment by the Parent to its subsidiary could be characterized as a loan given the expectation of eventual repayment, but could also be a contribution to capital.

236. See supra Part II.B.1–2.
to its insurer sibling because any payout on the contract will not cause a corresponding balance sheet decline to the insured because there is no direct ownership link. In addition, because the courts assume each subsidiary is a separate person, risk pooling occurs as a technical matter. The law of large numbers is likely to be operational, though this will depend on the overall number and type of covered assets.

In spite of the court decisions and the IRS’s concession, this arrangement is highly problematic. Because it is a closed system, the Parent experiences no net change to its portfolio, no matter what happens (again, this is similar to the economic family argument made by the IRS). That is, whether the premiums sit inside the captive or the captive pays out to one or more subsidiaries, from the Parent’s point of view, there is no net change, viewing the arrangement as a whole.237 Even if one takes as a requirement that each corporation be treated as a separate taxpayer, the Parent’s ability to control the arrangement substantively alters the economics. From each insured subsidiary’s point of view, so long as there are at least two subsidiaries being insured, there seems at first glance to be some possibility that a subsidiary insured will not ultimately receive back the premiums it paid in. But because the subsidiaries are under common control, it is likely (certainly more so than if unrelated parties were present) that the arrangement will continue until each insured receives a return of its premiums. Thus, the Parent’s ability to control its subsidiaries affects not only the value of the entirety but also affects whether the arrangement should be viewed as a series of closed, one-year contracts, or as a single, long-lived investment.

To see this, consider, for example, how easily the arrangement could be formally restated as a series of loans and repayments. For ease of illustration, the following example assumes away interest and present-value considerations.238 Imagine a subsidiary, B Inc., is organized as a bank. Its siblings, X Inc. and Y Inc., are each concerned about a possible

237. The IRS made this point in its early economic family guidance: “Because such amounts remain within the economic family and under the practical control of the respective parent . . . there has been no amount ‘paid or incurred.’” Rev. Rul. 77-316, 1977-2 C.B. 53, 54 (citation omitted). This Article argues that these amounts have been “paid or incurred” for a long-lived item of commensurate value.

238. With related corporations, an example could be formulated in terms of dividends and capital contributions. Loans between related corporations are, of course, possible, but highly problematic because of the ability to deduct interest payments (and the ability to situate interest income in low-tax jurisdictions). See, e.g., Stephen E. Shay, Mr. Secretary, Take the Tax Juice out of Corporate Expatriations, 144 TAX NOTES 473, 473-74 (July 28, 2014). Arguably, cash flows between related entities should generally be handled as equity transactions, such as dividends and capital contributions. For ease of illustration, the main text uses loans and repayments. See supra notes 38, 52.
event causing a $15,000 loss at some uncertain point in the future. \(X\) Inc. deposits $5000 at the beginning of each year for three years with its sibling, \(B\). Inc.; the event occurs at the end of Year 3, so \(X\) Inc. withdraws its $15,000 to cover the loss. \(Y\) Inc. also pays in $5000 at the beginning of Year 1 but experiences the event during Year 1. \(Y\) Inc. withdraws its saved $5000 and borrows $10,000 from its sibling bank subsidiary. \(Y\) Inc. then pays the loan back by paying $5000 in Year 2 and $5000 at the beginning of Year 3. In a situation where the insureds are all under common control, while it is certainly possible to imagine a situation in which one or more of the sibling subsidiaries does not receive back its premiums eventually, it is more probable that all contracts will continue so that the entire arrangement more closely resembles a series of loans and repayments. Given our current realization-based system, consideration of the probabilities suggests that the transactions should be held open—arguably indefinitely—and certainly not until it is clearer that there will be an unreimbursed loss.

The fact of common control also provides a situation where it is easier to engage in more overt tax avoidance, or even evasion. For example, the pricing of the contracts would be more easily manipulated. The parties would have greater ability to disguise long-term arrangements into annual contracts. Given the opportunities for avoidance and the economics of these arrangements, this Article in Part IV advocates for a bright-line prohibition on deductions for premiums paid to a related entity by taxpayers under common control. This would not mean that loss could never be taken. If the subsidiary actually experienced a casualty event, for example, it would be eligible to claim a casualty loss.\(^{239}\)

3. Parent, Siblings, and Non-Relatives as Insured Group

As was discussed in Part II, court decisions (with concession by the IRS) have held that the introduction of a significant number of unrelated insureds will allow even a parent corporation to deduct premiums paid to its own wholly owned captive subsidiary.\(^{240}\) The question addressed in this Subpart is whether the presence of unrelated parties should permit the Parent (or other related party) to take a deduction for each annual coverage period. The presence of unrelated parties does increase the likelihood that pricing manipulation has not been introduced, but this is

\(^{239}\) The payment from the “insurer” would not reduce the casualty loss. See supra note 52.

\(^{240}\) See supra Part II.B.1–2.
secondary to the question whether the unrelated parties affect the Parent's net wealth position.

The presence of a risk pool that includes a significant number of unrelated parties suggests a real possibility that payments made by the insurance subsidiary will go to insureds other than the Parent (to continue the slot machine analogy previously used, the Parent is allowing persons unrelated to it to take turns putting quarters in the slot machine). The presence of a large risk pool composed of unrelated insureds makes it less likely that the contract can be manipulated to ensure that the Parent effectively has a long-term investment (i.e., that the Parent will with certainty get a payout after multiple years). Thus, there is at least some possibility that the Parent experiences at least some net decrease relating to a particular year's contract.

At the same time, the Parent does retain a controlling ownership interest in the captive, with all that implies, including the Parent's ability to force continuation of the insurance arrangement. Under a mark-to-market valuation system, the Parent's overall net change in position would depend on the value of renewal rights (which are implied by the Parent's ability to control its subsidiary), the likelihood the Parent's premium payments will be paid out to unrelated parties (i.e., the size of the risk pool), and the value of its ownership in and control over the subsidiary (which could be smaller than 100%). The valuation issues would be complex and impractical to administer, but some generalizations can be drawn and used to support bright-line, rough justice rules. As will be discussed in more detail below, such rules could, for example, require discounting the amount of any premium deduction according to a formula tied to the volume of unrelated insureds (which the IRS's safe harbors already do) and to the Parent's percentage ownership stake.

4. Mutual Insurance, Otherwise Unrelated Insureds

Consider a group of sole proprietors who are all in the same industry and decide to band together to form their own risk pool. This mutually beneficial risk pool, which could be structured as a separate entity, would be owned and operated by the insureds. Such a structure is a type of captive insurance because the insureds are all related through their ownership of the common risk pool, but the insureds are not otherwise under common control. This type of captive arrangement has not drawn as much IRS scrutiny as captive structures involving insureds under common control, and the failure to explain the difference between
non-abusive mutual arrangements and abusive captive structures has been a problem in captive litigation.\footnote{See supra notes 102-07 and accompanying text.}

In a mutual arrangement, because the insured has both an ownership stake and an insurance contract, there is some similarity to a parent corporation insured by its own subsidiary. Unlike the parent-captive subsidiary examples discussed earlier, however, each owner-insured does not own 100\% of the insurer. As a result, as each owner-insured makes a premium payment, it is unlikely that any increase to the value of the ownership stake will precisely offset the decrease caused by the payment.\footnote{Though one can imagine situations where there is such a correlation—for example, premiums that are in proportion to one’s ownership interest instead of tied to the covered risk.} There is also less likelihood that a payout on the contract will be exactly offset by a corresponding decrease in the value of the ownership interest. Still, there is clearly going to be some offset, albeit one that is not precise. Valuation of the ownership interest is likely to be difficult because free transferability of ownership interests will be constrained by the mutual insurance arrangement. As a result, calculating any value offset caused by having both an ownership stake and an insurance contract will be difficult, but inexact bright-line rules could be adopted to govern deductions through these vehicles.

Even if the ownership stake can be separated from the insurance contract, other issues remain. Mutual arrangements may present a situation similar to that explored in the example regarding sibling captives. That is, mutual arrangements raise the question of how likely it is that the insureds will receive back their premiums through staying a sufficient length of time in the group—that is, whether there is a series of short contracts or a long-term, single bet. Because the insureds in the mutual arrangement are not under common control, however, it is far more possible that an insured getting a contract payment early in its participation in the group will exit the group. This in turn increases the likelihood that some of the insureds will not recover as much as they pay in. This evaluation requires that the timing of an individual insured’s experience of the covered event is not known (though the average loss for the group could still be predictable).

Certain types of risks and contracts, however, increase the likelihood that the insureds will stay in the group pool until each has received back as much as each has paid in. This would cause the arrangement to function economically like a series of loans and repayments among members of the group. As a result, one cannot create a blanket rule that any mutual arrangement created by unrelated insureds...
should lead to premium deductions for each contract year. Much depends on the contract terms, such as specification of a time horizon (whether in absolute or relative terms) or on refund rights unrelated to a bona fide risk adjustment.

To illustrate, consider two extreme cases. First, imagine a tontine, which is an agreement where a group of individuals contribute money to a fund (contributions may be lump sum or annual), but only one person—the last person still alive after all others have died—will receive a payout from the fund.243 Putting aside whether this is “insurance” or not, even if there were a decrease in wealth on payment it would be nondeductible personal consumption, the contract does not close as to a particular person until she dies or everyone but her has died. Indeed, as each person dies, the value of the tontine arrangement likely increases for those still alive so that there is an incentive to stay in the group. There is clearly a loss to be claimed on the final tax return for each decedent, and the winner should be able to reduce her recovery by her prior contributions.

A tontine, of course involves events that are certain to occur eventually—the death of everyone in the group but one (and the arrangement may even hasten deaths given the incentives a tontine sets into motion). Imagine instead an arrangement involving a risk at the other end of the certainty continuum. Suppose a group forms a pool to cover something that is highly improbable—such as infection by fire-starting dragonscale.245 Each member of the group agrees to place money in the pool annually for a period of twenty years; if the plague of fires has not occurred by that point, then the money will be refunded proportionally to the owners (including any return earned on the money while being held in the pool). If the plague does occur, the money in the pool will be paid out as damages occur, up to some predetermined threshold but one that will not automatically lead to everyone getting an equal share. The implausibility of the event causes this mutual arrangement to appear more similar to a mutual savings vehicle.

These two examples demonstrate that unrelatedness of the insureds to each other is insufficient, and they highlight again that factors such as certainty about the timing of the event or the likelihood of obtaining a refund should affect premium deductibility.

244. See id. at 757 n.4, 774-76.
245. See HILL, supra note 214, at 29-30, 32-34.
IV. REFORM RECOMMENDATIONS

The preceding examples all focused on the value of the contract purchased with the premium rather than on whether the thing purchased was insurance or not. The examples reveal that the closer an arrangement is to commercial insurance, the more likely it is that the value of the purchased coverage declines to zero by the end of each formal contract term. On the other hand, the relatedness of the parties or the terms of the contract may well cause the value of the arrangement to linger beyond the formal end date of a particular annual contract. Thus, the IRS’s tactic of comparing a particular captive insurance arrangement to a commercial arrangement may lead to the same result as that using an approach more expressly based in income tax principles. That is, by denying deductions for arrangements that do not look like standard commercial insurance, they would get the right result most of the time and so arrive at a serviceable bright-line approach.

The problem is that the IRS has not been successful in implementing that approach. Insurance means different things to different regulators, and while a narrow definition may suit the IRS, it does not suit state insurance regulators. Using normative income tax tools—such as mark-to-market or Samuelson depreciation—to show why a premium payment for commercial insurance on business property should lead to a deduction could help the courts separate income tax interests from the interests of state regulators. Although it is likely not practicable to engage in normative valuation of complex contracts, looking to how hypothetical situations would fare under economic valuation, in conjunction with a consideration of our current tax system’s approach to contingencies, suggests paths for bright-line rules. This Part suggests three categories for bright-line rules.

First, premium deductions should be restricted for related parties. If all the insureds and the insurance company are under common control, no deduction should be permitted. As discussed in the preceding Part,


247. See supra notes 180-83 and accompanying text.

248. This Article has not discussed reform at the end of the contract—on the payout of the proceeds, and reform could be suggested at that point as well, particularly as it relates to character.

249. The Code already contains various methods for measuring control that could be utilized. For example, I.R.C. § 1504(a) (2012) defines “affiliated group,” looking to interrelated chains of eight percent of ownership and control, measured by voting power and value. See also supra Part III.C.2 (discussing insurance plans where all insureds are under common control). The transfers
in such a situation, it is highly unlikely that each coverage period brings with it a decline in value to the insured, even taking into account the separate taxpayer status of each entity. The open transaction doctrine, which is our current system’s accommodation to the difficulty of valuing contingencies, further suggests denial of deductibility when the relatedness of the parties or terms of the arrangement imply a substantively longer relationship. Ignoring the null economic impact of a transfer from one subsidiary to another, both under common control, because each of the subsidiaries has a separate state law charter is to elevate form over economic substance. Because there is clearly no decline in economic value for premiums paid into a closed, controlled system, premium deductions should not be permitted, whether paid by the parent or by the sibling subsidiaries of the insurance captive.

If the system is not entirely closed, but the insurance company is still related to its insureds, premium deductions in some situations may be acceptable. This Article proposes that, assuming the second or third rule categories discussed below do not apply, the parent and siblings of an insurance company: (1) may deduct premiums if more than half of the insureds (measured both by the number of insureds and by the amount of coverage) are unrelated to each other, not taking into account relatedness through ownership in the insurance company (i.e., a mutual insurance arrangement); (2) but will have any resulting premium deduction reduced depending on the degree of relatedness.

If the relatedness threshold is sufficiently low—for example, twenty percent or lower—then no premium reduction would be required. Relatedness between levels evidencing a high degree of control (for example, eighty percent) and the lowest threshold would result in proportional reductions to the deductions, rather than trigger an all-or-nothing deduction. The suggested rules tied to relatedness would require making complex determinations, but having rules tied to relatedness thresholds are already quite common in the Code.

would be treated as dividends and contributions to capital, as discussed supra in notes 38 and 52.

250. For examples supporting the need for this proposal, see supra Part III.C. The Code also suggests a possible template through the dividends received deduction provisions, which allow for a larger deduction depending on the percentage of ownership by the payee corporation in the payor corporation. I.R.C. § 243. More recently, as discussed supra note 66, the 2017 tax legislation added a minimum tax for base erosion payments, which may include premiums paid to insurance companies not taxed as U.S. companies.

251. Fifteen percent is suggested here as it is already consistent with one IRS safe harbor. See supra note 107 and accompanying text.

252. See I.R.C. §§ 243, 351, 368, 1504.
Second, no premium deduction should be allowed if testing for the covered event will occur more than twelve months after the payment. This would prevent deductions for “premiums” on what is economically a long-term investment contract, and would apply whether or not the insureds are related to each other or to the insurance company (thereby applying not just as to formal captive arrangements). The happening of the covered event would trigger realization of any losses (or gains). Current regulations already require capitalization of prepayments, but the proposed rule would make clear that if the covered event is certain to occur at a particular time or if the amount of coverage payout will be tested at a certain time (as in the R.V.I. case), the premiums could not be amortized and would instead be treated as continuing investments in a long-term contract.

Third, no deduction should be allowed until the year the contract is abandoned or the event occurs if coverage is for non-physical harm resulting from systemic market forces. There is likely to be overlap between the types of arrangements targeted by the second rule category and this rule because such non-physical harms are certain to occur eventually (albeit at an unknown point in time). Such contracts are similar to long-term saving accounts, investment contracts, or derivatives, such as swaps. As with the second proposed rule, this rule would apply whether or not the insureds are related to each other or to the insurance company. The tax consequences would be determined when the contract ends, including if it is abandoned without payment being made to the “insured.” Anti-abuse rules would be required in determining whether a loss would be allowed upon the closing of a contract, including its abandonment. The Code already contains similar provisions, such as the wash sale rules, which limits losses on stock sales when substantially identical stock is purchased within a short period of time of the sale. For contracts between related parties, abandonment would not give rise to a deduction.

These last two categories are intended to limit the ability of taxpayers to design “insurance” where the amount paid as a “premium” is structured to be the present value of an eventual, certain payout

253. For examples supporting the need for this proposal, see supra Part III.B.4.
254. See supra note 135 and accompanying text (discussing rent-a-captives).
255. Treas. Reg. § 1.263(a)-4(d)(3), (f) (2018); see also supra notes 32-36 and accompanying text.
257. For examples supporting the need for this proposal, see supra Part III.B.7.
amount. If the parties are unrelated, the difference between the premiums and the payouts should be treated as income, such as through treating the transaction like debt issued with original issue discount.\textsuperscript{259} If the parties are related and are corporations, it may be more appropriate to treat the premiums and payouts as relating to equity interests, so that they are handled as dividends from the payor "insurance" corporation to the parent followed by capital contributions to the recipient "insured" corporation.\textsuperscript{260}

Of course, the introduction of new bright-line rules raises the possibility of new techniques to bypass the new rules. Substance-over-form considerations would need to guide implementation of such rules. Apart from whether the proposed rules would work, there is also the practical problem of how such rules would be enacted.

Congressional intervention is required for various reasons. As previously mentioned, business- and insurance-related insurance premium payments have long been viewed as "ordinary and necessary expenses" authorized by general statutory language applicable to business and investment activity\textsuperscript{261} and interpreted as such in Treasury regulations.\textsuperscript{262} Relatedly, because there is already a significant number of court decisions in this area (although no Supreme Court decision specific to captive insurance\textsuperscript{263}), any regulations introduced would be "fighting" regulations.\textsuperscript{264} Finally, the definition of "insurance" is inextricably linked to the tax treatment afforded by the Code to insurance companies. As a result, changes to deductibility for premiums will require coordination regarding the tax treatment of insurance companies, which is likely to prove an even thornier issue.

The need for congressional action may make the possibility of reform seem remote. Congress has, however, already shown some willingness to engage in reform in the captive insurance area. In 2015, as described in Part II, an (albeit flimsy) ownership diversification rule was added to a provision granting additional tax benefits to certain small insurance companies, and Congress has also enacted reforms aimed at

\begin{tabular}{l}
\textsuperscript{259} I.R.C. § 1272. \\
\textsuperscript{260} Rev. Rul. 77–316, 1977–2 C.B. 53 \textit{passim}; see also supra notes 38, 52. \\
\textsuperscript{261} I.R.C. §§ 162(a), 212; see also Taylor, supra note 8, at 888. \\
\textsuperscript{262} Treas. Reg. § 1.162–1(a) (2018). There is no specific parallel provision in the section 212 Treasury regulations, but the "ordinary and necessary expenses" language has the same general meaning in both statutes. \textit{id.} § 1.212–1(a)(2); see supra note 30 (discussing miscellaneous itemized deductions and the changes added by the 2017 legislation). \\
\textsuperscript{263} See supra Part II.B. \\
\end{tabular}
cross-border captives and recently undertook some modifications to insurance taxation.265

V. CONCLUSION

Captive insurance arrangements, and the IRS’s attempts to police them, illustrate the continued ability of businesses to exploit the tax system’s recognition of separate business identity to gain income tax benefits. The IRS’s current approach to identifying problematic insurance structures illustrates a tension between the IRS, the courts, and state insurance regulators. In particular, the courts have not acceded to the IRS’s attempt to impose a particular definition of insurance and have continued to respect the separate taxpayer status of each business entity. This Article considers how a series of hypothetical insurance arrangements would fare under normative income tax principles. That analysis demonstrated that the presence of various facts, such as the relatedness of the parties and timing certainty as to covered events, indicates that for many suspect insurance arrangements, the insured has failed to experience annual, net declines in wealth relating to the contract. This Article then proposed three bright-line rule categories, which draw both on normative income tax analysis and on our current system’s adoption of the realization requirement and its approach to contingent events. These rules include denying deductions for premiums paid when there is a group of entities under common control and limiting deductions for insureds that are also owners even when such owners do not have a controlling interest. Implementation of the proposed bright-line rules would almost certainly require congressional intervention.

265. See supra Part II.A; supra notes 53-54, 66 (discussing changes to insurance taxation added by the 2017 tax legislation).