Humana Inc. and Subsidiaries v. Commissioner of Internal Revenue, 88 T. C. 197 (1987)

Payments to wholly-owned captive insurance subsidiaries are not deductible as insurance premiums because they do not shift risk outside the economic family.

Summary

Humana Inc. established a captive insurance subsidiary, Health Care Indemnity, Inc. (HCI), to provide liability insurance after its previous coverage was canceled. Humana paid premiums to HCI, which were then allocated among its subsidiaries. The Tax Court held that these payments were not deductible as insurance premiums because they did not shift risk outside the economic family of the parent and its subsidiaries. The court's decision extended prior rulings that payments to wholly-owned captives by the parent company are not deductible, applying the same rationale to payments from subsidiaries to the captive insurer.

Facts

Humana Inc. , facing a lack of available insurance coverage for its hospitals, established Health Care Indemnity, Inc. (HCI) in Colorado as a captive insurance subsidiary. HCI was jointly owned by Humana Inc. and its wholly-owned foreign subsidiary, Humana Holdings, N. V. Humana Inc. paid premiums to HCI for general liability and malpractice insurance, which were then allocated among its operating subsidiaries based on the number of occupied hospital beds. The total premiums paid were deducted on Humana's consolidated federal income tax returns. The Commissioner of Internal Revenue challenged these deductions, asserting that the payments did not constitute deductible insurance premiums.

Procedural History

The Tax Court initially issued a memorandum opinion disallowing the deductions, which was later withdrawn upon Humana's motion for reconsideration. The case was then fully argued and decided by the court, with the final decision affirming the non-deductibility of the payments to HCI as insurance premiums.

Issue(s)

1. Whether the sums paid by Humana Inc. to HCI on its own behalf are deductible as ordinary and necessary business expenses for insurance premiums.
2. Whether the sums charged by Humana Inc. to its operating subsidiaries and deducted on the consolidated income tax returns are deductible as ordinary and necessary business expenses for insurance premiums.

Holding

1. No, because the payments to HCI by Humana Inc. did not shift risk outside the

economic family, as per the court's prior decisions in Carnation and Clougherty.
2. No, because the payments from the subsidiaries to HCI also did not shift risk outside the economic family, extending the rationale of Carnation and Clougherty to the brother-sister relationship.

Court's Reasoning

The court's reasoning was grounded in the principles of risk-shifting and risk-distribution, essential elements of insurance. It followed its prior decisions in Carnation Co. v. Commissioner and Clougherty Packing Co. v. Commissioner, where payments to wholly-owned captives by the parent were held non-deductible due to the lack of risk transfer. The court extended this rationale to the brother-sister relationship between Humana's operating subsidiaries and HCI, finding no risk transfer occurred. The court emphasized that the economic family concept was not adopted per se but was relevant to the analysis of risk transfer. Expert testimony supported the court's conclusion that the arrangements did not constitute insurance from an economic and insurance theory perspective. The court also rejected Humana's argument that certain payments were deductible as business expenses, reclassifying them as non-deductible additions to a reserve for losses.

Practical Implications

This decision has significant implications for companies utilizing captive insurance arrangements. It establishes that payments to wholly-owned captives, whether from the parent or its subsidiaries, are not deductible as insurance premiums if they do not shift risk outside the economic family. This ruling limits the tax benefits of captive insurance for closely held groups and may encourage companies to seek alternative risk management strategies or to structure their captives to include unrelated parties to achieve risk transfer. The decision also impacts the captive insurance industry, potentially affecting how captives are formed and operated to meet the criteria for deductible premiums. Subsequent cases, such as Stearns-Roger Corp. v. United States and Mobil Oil Corp. v. United States, have followed this ruling, further solidifying the principle that true risk transfer is required for deductible insurance premiums.