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Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981)

Jorge E. Alvarez

Income Tax—FOREIGN INCOME—INSURANCE PAYMENTS TO WHOLLY-OWNED FOREIGN CAPTIVE INSURANCE COMPANY ARE RECAST AS CAPITAL CONTRIBUTIONS—*Carnation Co. v. Commissioner,* 640 F.2d 1010 (9th Cir. 1981).

The law of federal income taxation is indisputably rife with unanswered questions of congressional intent and statutory construction. Nonetheless, there is an uncontroverted principle in regard to the deductability of casualty insurance premiums paid in the course of business to unrelated insurance companies. The clear rule of taxation may be found in Internal Revenue Code section 162[1] and Treasury Regulations section 1-162-1(a),[2] which together allow deductions from gross income of amounts paid for insurance and for other ordinary and necessary business expenses. Similarly clear is the rule with respect to taxpayers who elect to self-insure. Since the earliest federal income tax opinions, tribunals and revenue rulings have repeatedly held that self-insurance funds owned and controlled by the taxpayer or his agent do not represent bonafide insurance for tax purposes and, hence, may not be accumulated with before-tax dollars.[3]

As is often the case, however, these clear rules of taxation invited creation of tax-avoidance devices that appear to be one thing but that in substance may be something altogether different. In recent years, a number of large capital-intensive firms have turned to a method of insurance that attempts to secure a variety of tax benefits, including deductions for premiums, while providing much of the flexibility and cost advantage that a self-insurance fund can provide. This method involves the creation of a foreign "captive" insurance company that insures only the risks of its parent and the parent's subsidiaries.[4] In the early years of this phenomenon, the

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1. I.R.C. § 162. All references to sections hereinafter will be to sections of the Internal Revenue Code unless specifically noted otherwise.

2. Treas. Reg. § 1-162-1(a) (1980).

3. *See* Steere Tank Lines, Inc. v. United States, 577 F.2d 279 (5th Cir. 1978), *cert. denied,* 440 U.S. 946 (1979); Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930), *cert. denied,* 284 U.S. 654 (1931); Appeal of Pan-American Hide Co., 1 B.T.A. 1249 (1925); Rev. Rul. 275, 1960-2 C.B. 43; Rev. Rul. 485, 1957-2 C.B. 117. *See generally* MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.101 (1979 & Supp. 1981).

4. Captives commonly arise under the laws of jurisdictions that provide lenient regulation and taxation of insurance. Any of a series of purposes could lead a large firm to organize a captive. A firm may desire to insure risks peculiar to the industry, against which few readily available or reasonably priced policies may be obtained in the marketplace. Risks of this type may include political risks, products liability risks, strike risks, or pollution liability risks. Also, a firm may desire to obtain for its affiliated group the underwriting profits, investment income, and cash flow that would otherwise be lost to an unrelated insurer. Finally, a firm may use a captive to gain access to the reinsurance market. *See generally,*

Commissioner of Internal Revenue (hereinafter Commissioner) apparently gave tacit approval to the sought-after tax benefits.[5] It seems that if the captive's shareholders are a number of unrelated firms, or if unrelated parties are insured, the Commissioner may yet allow the desired tax benefits.[6] Parents of foreign captives that insure only the risks of the controlling shareholder, however, can no longer expect clear, uncontroverted treatment of their insurance transactions. *Carnation Co. v. Commissioner*,[7] a recent Ninth Circuit decision, raises significant questions concerning the nature for tax purposes of such foreign insurance subsidiaries and about the reach of pervasive congressional policy considerations that generally regard a corporation and its shareholders as separate entities.

In 1971 Carnation Company organized Three Flowers Assurance Company under the laws of Bermuda, primarily for the purpose of insuring the risks of Carnation and its subsidiaries.[8] Rather than directly write policies for the affiliated group, Three Flowers contracted with American Home Assurance Company, an unrelated firm, to reinsure 90 percent of American Home's liability under a three-year policy that Carnation had purchased from American Home. Concern by American Home over Three Flowers' ability to

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Brown, *Bermuda Captive Insurance Companies: The New Capacity*, 79 BEST'S REV.-PROP. & CAS. INS. ED. 22 (Sept. 1978); Comment, *Federal Taxation Concepts in Corporate Risk Assumption: Self-Insurance, The Trust, and the Captive Insurance Company*, 46 FORDHAM L. REV. 781, 811-12 (1978); O'Brien, *Captive Off-Shore Insurance Corporations*, 31 N.Y.U. TAX. INST. 665, 667-69 (1973); Saggese, *Utilization of a Foreign Captive Insurance Corporation*, 644 INS. L.J. 525 (Sept. 1976); Spector, *Captive Insurer and Corporate Entities*, 57 TAXES 313 (May, 1979).

5. The earliest evidence of the Commissioner's objection to foreign captives appears to be a 1972 amendment to the Internal Revenue Manual which directed auditors to disallow deductions for premiums paid, *See generally* Pine, Stanger, and Wright, *IRS Revenue Ruling 77-316: Avoiding Its Consequences*, 25 RISK MANAGEMENT 11 (April, 1978); Freeman, *infra*, note 6. Nevertheless, commentators felt that courts would not sustain the disallowances because the Commissioner's burden to prove that a captive was not a "bona fide corporate entity, or that it was not a true insurance company" would be unbearable in most cases. Pine, *The case for 'captive' insurers*, 50 HARV. BUS. REV. 142, 146 (Nov.-Dec. 1972).

6. *See, e.g.*, Rev. Rul. 338, 1978-2 C.B. 107 (premiums paid to a captive of numerous unrelated shareholders held deductible); Rev. Rul. 120, 1980-1 C.B. 41 (premiums paid to a mutual insurance company covering the risks of 5,000 unrelated member-policyholders held deductible). *Cf.* Theodore v. Commissioner, 38 T.C. 1011 (1962), *acq.* 1966-2 C.B. 7 (premiums paid to a mutual insurance company held deductible when the insurer covered only the risks of the taxpayer, business associates, employees, and relatives, and when over three-fourths of the voting rights in the insurer were owned by taxpayer). *See also* Freeman, *Revenue Ruling 77-316's Implications for Captives*, 658 INS. L.J. 678 (Nov. 1977). The Commissioner's position with respect to domestic captives insuring only the risks of the parent remains unclear. *See also, infra*, note 39 and accompanying text.

7. 640 F.2d 1010 (9th Cir. 1981).

8. Carnation Co. v. Commissioner, 71 T.C. 400, 402 (1978).

abide by its contractual obligation led Carnation to enter into an agreement with Three Flowers providing that, on demand of either party, Carnation would purchase 288,000 shares of new-issue common stock from Three Flowers at $10 per share. Carnation's total capital contribution to Three Flowers before that time had been $120,000.[9]

In 1972, having received a $1,950,000 annual premium from Carnation, American Home paid $1,755,000 to Three Flowers pursuant to their reinsurance agreement.[10] Carnation deducted the full amount of the premium paid to American Home under section 162. Because Carnation was subjected to the subpart F rules of income attribution by virtue of Three Flowers' status as its controlled foreign corporation in 1972, Carnation returned to gross income $1,647,216 as largely representing the amount of income Three Flowers had received from the insurance of United States risks.[11] Having paid a variety of foreign taxes, Carnation also claimed a section 901 foreign tax credit against its domestic tax bill and included the subpart F attributed income in computing its section 904 foreign tax credit limitation.[12] Characterizing the $1,755,000 paid Three Flowers by American Home as a capital contribution by Carnation, the Commissioner (1) disallowed the premium deductions to the extent the risks were borne by the captive; (2) redetermined Carnation's subpart F income to be $50,616; and (3) reduced the allowable tax credit by $781,793.[13]

In litigation, the Tax Court identified four theories in the Commissioner's brief, variously suggesting that the payments were (1) a form of non-deductible self-insurance; (2) an outlay not paid or incurred within the meaning of section 162; (3) essentially a sham because nothing of value had been received in return; and (4) that the agreements could not be construed as insurance for tax purposes because no risk-shifting and risk-distribution had taken place.[14] Reaching only the argument that the agreements were not insurance for tax purposes, the Tax Court held for the Commis-

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9. *Id.* at 402-03.

10. *Id.* at 404.

11. *Id.* I.R.C. §§ 951-64, generally referred to as subpart F, provide a scheme of attribution to domestic shareholders of income earned by their controlled foreign corporations. Their purpose is to combat avoidance of domestic taxes by carrying on business through corporations created in tax haven jurisdictions. *See* R. RHOADES & M. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS, § 3.01.

12. 71 T.C. at 404.

13. *Id.* at 404-05.

14. *Id.*

sioner largely on the precedent of *Helvering v. Le Gierse.*[15]

In *Le Gierse,* an eighty-year-old woman had executed two contracts with a life insurance company on the same day. One was a single-premium annuity contract costing $4,179 and providing a lifetime monthly income of $49.15, and the other a single-premium life insurance policy costing $22,946 and paying $25,000 to the beneficiary upon the insured's death.[16] The insured died less than a month later, having paid a total consideration of $27,125. The beneficiary contended that the proceeds were excludible from the decedent's gross estate because the estate tax statute then in effect included insurance proceeds only to the extent they exceeded $40,000.[17] The Commissioner, on the contrary, suggested that the payment was not receivable as insurance within the meaning of the statute. Unable to discover a definition of life insurance for purposes of the statute, the Supreme Court held that the term "insurance" was to be given its common meaning, necessitating a shifting and distribution among a group of individuals of the risk of premature death by any one member.[18] Finding that Mrs. Le Gierse's life insurance policy would not have been issued without the simultaneous sale of the annuity, the Court, applying to its risk-shifting test, refused to acknowledge any shift or distribution of risk and held that the agreements did not constitute insurance.[19]

Applying the *Le Gierse,* test to *Carnation,* the Tax Court found the agreements among Carnation, American Home, and Three Flowers to be interdependent and thus to be considered together.[20] Emphasizing that ninety percent of the liability under the American Home Policy was reinsured by a corporation which could demand at any time $2,880,000 in additional funds from the insured, the court held that the agreement between Carnation and American Home had shifted the risk of loss only to the extent that American Home had not reinsured with Three Flowers.[21] On appeal, the Ninth Circuit, deferring to the Tax Court's "special ex-

15. 312 U.S. 531 (1941).
16. *Id.* at 536.
17. *Id.* at 538.
18. *Id.* at 538-39.
19. *Id.* at 540. Mrs. Le Gierse conceivably could have lived long enough to have received a total insurance benefit greater than her total layout. The Court disposed of that notion, however, by stating that the risk of Le Gierse's longevity was more akin to the risk assumed by a bank when it invests its depositors' funds than to the risk normally assumed in the course of providing life insurance. *Id.* at 544.
20. 71 T.C. at 408-09.
21. *Id.* at 409-10.

pertise," unqualifiedly affirmed.[22]

Not inconsistent with the Commissioner's arguments in *Carnation* is Revenue Ruling 77-316,[23] issued shortly before the filing of the Tax Court's opinion. Unmentioned by the Tax Court, but unfortunately cited by the Ninth Circuit, the ruling presented three factual settings alternatively involving (1) affiliated domestic insureds paying fair market premiums to a foreign captive directly,[24] (2) the same insureds paying an unrelated firm that partly reinsured with the captive,[25] and (3) the insureds paying the captive which then partly reinsured with an unrelated firm.[26] Although no agreement by the insureds to provide additional funds on demand of the insurer was present in any of these circumstances, the ruling disallowed any deduction to the extent the risk was borne by the captive.[27] The ruling's logic was premised upon the assertion that movements of cash among a family of closely-held corporations are as movements of cash among accounts within one corporation, and

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22. 640 F.2d at 1011.
23. 1977-2 C.B. 53.
24. The first factual setting in Rev. Rul. 77-316 is:

> During the taxable year domestic corporation *X* and its domestic subsidiaries entered into a contract for fire and other casualty insurance with *S1*, a newly organized wholly-owned foreign "insurance" subsidiary of *X*. *S1* was organized to insure properties and other casualty risks of *X* and its domestic subsidiaries. *X* and its domestic subsidiaries paid amounts as casualty insurance premiums directly to *S1*. Such amounts reflect commercial rates for the insurance involved. *S1* has not accepted risks from parties other than *X* and its domestic subsidiaries.

Id.

25. The second factual setting provided in Rev. Rul. 77-316 is:

> The facts are the same as set forth in *Situation 1*, *supra* note 24, except that domestic corporation *Y* and its domestic subsidiaries paid amounts as casualty insurance premiums to *M*, an unrelated domestic insurance company. This insurance was placed with *M* under a contractual arrangement that provided that *M* would immediately transfer 95% of the risks under reinsurance agreements to *S2*, the wholly-owned foreign "insurance" subsidiary of *Y*. However, the contractual arrangement for reinsurance did not relieve *M* of its liability as the primary insurer of *Y* and its domestic subsidiaries; nor was there any collateral agreement between *M* and *Y*, or any of *Y*'s subsidiaries, to reimburse *M* in the event that *S2* could not meet its reinsurance obligations.

Id.

26. The third factual setting in Rev. Rul. 77-316 is:

> The facts are the same as set forth in *Situation 1*, *supra* note 24, except that domestic corporation *Z* and its domestic subsidiaries paid amounts as casualty insurance premiums directly to *Z*'s wholly-owned foreign "insurance" subsidiary, *S3*. Contemporaneous with the acceptance of this insurance risk, and pursuant to a contractual obligation to *Z* and its domestic subsidiaries, *S3* transferred 90% of the risk through reinsurance agreements to an unrelated insurance company, *W*.

Id.

27. *Id.*

thus insufficient to satisfy the *Le Gierse* risk-shifting test or to escape the general preclusion of deductibility of self-insurance contributions.[28] The disturbing consequence of the ruling is that, notwithstanding its professed regard for the separate identities of the parent and captive corporations, the ruling *per se*, and without cited authority, disallows any payment to a foreign captive for insurance of the risks of the affiliated group. Under this analysis, such agreements are always "designed to obtain a deduction by indirect means that would be denied if sought directly," intimating a conclusive presumption of sham or exclusive tax avoidance purpose.[29]

Two of the four respondent arguments identified by the Tax Court present the essence of Revenue Ruling 77-316.[30] Interestingly, the Commissioner failed to present any of a series of other possible anti-captive weapons, including section 482.[31] Instead, the Commissioner sought to recast Carnation's deductions as capital contributions to propel the case law in the direction of his position in Revenue Ruling 77-316.[32] An examination of the rules of foreign-related tax as they apply to *Carnation* is of help in under-

28. *Id.* at 54-55.

29. *Id.* at 55.

30. The arguments proposing that the premiums were not "paid or incurred" and that they were non-deductible self-insurance appear to be the same argument perhaps partly because both suggest an unprincipled disregard of Three Flowers' separate corporate identity so that the pool of funds could be treated as a self-insurance fund.

31. I.R.C. § 482 supplies the Commissioner with statutory power to allocate gross income, deductions, credits, or allowances among organizations controlled by the same interests whenever he feels allocation is necessary to clearly reflect the income of these organizations. In *Carnation*, the Commissioner could have argued I.R.C. § 482 by alleging that the premiums paid indirectly to Three Flowers were in excess of a fair market premium for the insurance protection received, if any. *See, e.g.*, Oil Base, Inc. v. Commissioner, 362 F.2d 212, (9th Cir. 1966), *cert. denied*, 385 U.S. 928 (1967) (deductions for commissions paid a wholly-owned foreign subsidiary were partly disallowed under § 482 because they were twice those paid unrelated parties for similar services). Another possible argument the Commissioner might have raised would have been a § 269 disallowance of deductions, credits, or allowances claimed by virtue of acquisition or formation of a corporation with the primary motivation of securing tax benefits. Internal Revenue Manual § 45(11)9 directs auditors to disallow deductions for premiums paid foreign captives by virtue of both above-mentioned approaches. *See* Internal Revenue Service, *Captive Offshore Insurance or Reinsurance Companies*, 2 INT. REV. MAN.—AUDIT (CCH) 8215-2 (1980).

32. Neither of the approaches mentioned in footnote 31 would constrict the use of wholly-owned foreign captives as surely and in as many circumstances as would an adoption of the Revenue Ruling 77-316 *per se* disregard of the separate corporate identity. I.R.C. § 482 would usually lead to only a partial reallocation of income among the entities. I.R.C. § 269 would succeed only when none of the numerous non-tax-avoidance reasons for using foreign captives was significantly present. *See also* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, §§ 13.21, 13.32 (1966).

standing the possible motive behind the Commissioner's position.

Three Flowers' status as Carnation's foreign controlled corporation was determined under the section 957(a) definition, which includes a foreign corporation of which 50 percent of total voting power is actually or constructively held by United States shareholders on any day of the corporation's taxable year.[33] The subpart F income at issue is defined by section 952(a) as income received by a controlled foreign corporation from a series of events; only the insurance of United States risks is relevant here. The United States shareholders, defined by sections 951(b), 957(d), and 7701(a)(30), actually or constructively owning stock in such corporation, must include in their gross income a pro rata share of their corporation's income.[34] Only the shareholders, not the foreign corporation, are affected by subpart F.

Although subpart F income is subject to foreign taxation when first received by the foreign corporation, section 960 mitigates the double-tax burden on the shareholder by deeming a pro rata share of the corporation's foreign tax payment on the subpart F income to have been paid by the shareholder.[35] Having constructively paid foreign taxes, the shareholder may elect to either take a section 164(a)(3) deduction for foreign taxes paid,[36] or have a section 901 credit applied directly against his domestic taxes.[37] If the share-

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33. I.R.C. § 957(b) provides a special rule for defining controlled foreign corporations for purposes of attributing income earned from insurance of United States risks. With respect to such income, a foreign corporation is deemed to be "controlled" if more than 25% of the total combined voting power of all classes of stock entitled to vote is actually or constructively owned by United States shareholders on any day of its taxable year. Because Three Flowers was wholly-owned by United States shareholders, it fell within the more limited reach of I.R.C. § 957(a).

34. I.R.C. § 951(a) requires that any person who is a United States shareholder on the last day of a taxable year in which his corporation was a controlled foreign for an uninterrupted period of 30 days include in his gross income a pro rata share of the corporation's subpart F income. I.R.C. § 951(b) defines a United States shareholder as a United States person who actually or constructively owns at least 10% of the total voting power of a foreign corporation, for purposes of subpart F. Section 957(d) adopts for subpart F purposes the definition of United States person found in I.R.C. § 7701(a)(30) which defines United States persons as United States citizens, residents, domestic partnerships and corporations, and most estates and trusts.

35. The constructive payment, however, is attributed only to domestic corporate shareholders via I.R.C. § 960(a). I.R.C. § 902 provides a broader attribution of foreign taxes paid, catching domestic corporations owning as little as 10% of a foreign corporation's stock. This rule, however, is limited to taxes paid on the portion of the foreign corporation's income paid as dividends to the domestic parent.

36. I.R.C. § 164(a)(3) allows deduction of "state and local, and foreign, income, war profits, and excess profits taxes."

37. I.R.C. §§ 901(a) and (b) allow citizens and domestic corporations electing subpart A

holder elects section 901, however, his credit will be limited by section 904. Section 904 precludes domestic payers of foreign taxes from successfully claiming credits in amounts exceeding the ratio of the taxpayer's foreign source income to his total income, multiplied by the amount of domestic tax against which the credit is taken. For example, a domestic corporation receiving $200,000 total income, $50,000 of which is subpart F income, may receive a maximum of 50/200 of its domestic tax bill as a credit for foreign taxes paid. Notwithstanding the section 901 credit, it is therefore possible for a domestic taxpayer's combined foreign and domestic tax bill for any particular year to be greater than the tax bill it would be liable for if all the income was of domestic origin.[38]

Carnation may have found itself in such a situation prior to the formation of Three Flowers. The primary purpose for organizing Three Flowers in a low-tax jurisdiction may have been to create subpart F income for Carnation via payments leading to a section 162 deduction. Under such an arrangement, Carnation's allowable section 901 credit could be increased without sizeably increasing either its foreign tax bill or its domestic pre-credit tax bill. This consequence of the use of foreign captives wholly-owned by domestic insureds may be the major reason behind the Commissioner's determined attack against their use.[39]

Toward that end, Revenue Ruling 77-316, which perfunctorily disregards the separate corporate identities, could be a most effective anti-captive device. Such an approach, however, is not supported by law. Federal tax statutes generally recognize the sepa-

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foreign tax credit treatment to claim a credit against their domestic tax bill of any income, war profits, or excess profits taxes paid to any foreign government.

38. The purpose of the I.R.C. § 904 credit limit is to extract from domestic taxpayers receiving some foreign source income roughly as much federal tax, before carrybacks and carryforwards, as would be extracted from those who receive the same amount of income entirely from domestic sources. *See* R. Rhoades & M. Langer, Income Taxation of Foreign Related Transactions, § 5.04 (1980). For example, assuming a 40% domestic tax rate and a 60% foreign rate, the domestic corporation described in text would pay $30,000 in foreign taxes and $50,000 in domestic taxes if the full amount of foreign tax could be credited. The taxpayer with only domestic source income would of course, pay $80,000 in domestic taxes. Under I.R.C. § 904, the corporation could credit only 50/200 of $80,000, or $20,000. Hence, it would pay $60,000 in domestic tax, but become entitled to a two-year $10,000 carryback for foreign taxes paid but uncredited, any unabsorbed amounts, any excess to be carried forward five years. I.R.C. § 904(c).

39. Interestingly, the directives in Internal Revenue Manual § 45(11)9 aim specifically at foreign wholly-controlled captives, presumably not at those created in favorable domestic jurisdictions. It is possible, however, that the Commissioner may be preparing to assert his position against domestic captives at a future time. *See* Pine, Stanger & Wright, note 5 *supra*, at 18.

rate identity of corporations and their corporate or non-corporate shareholders, providing each a scheme of distinct principles of taxation.[40] Tax decisions disregarding corporate separateness are generally limited to cases in which there has been a finding of (1) sham or no purpose other than tax avoidance,[41] (2) inextricable fusion of the shareholder's business activity with that of the corporation,[42] (3) assignment of income between corporation and shareholders,[43] or (4) the absence of any economic significance in the corporation's activities.[44] This being the law, Revenue Ruling 77-316 presents the untenable proposition that, because premiums paid captives are to be treated as contributions made to a self-insurance fund, all agreements for insurance with wholly-controlled foreign captives must be of the kind of tax-abusive character that would lead to a disregard of the separate corporate identity notion. The Tax Court specifically refused to address arguments disregarding separate corporate identities.[45] The Ninth Circuit, however, citing Revenue Ruling 77-316, noted the similarity of the ruling[46] to the facts of *Carnation,* and rejected without explanation Carnation's protest that the ruling required an impermissible disregard of the separate identity of the captive.[47] It is unfortunate that a federal appeals court so closely approached adoption of the revenue ruling's principle.

The *Le Gierse* approach so heavily relied upon by both the Tax Court and the Ninth Circuit, though more narrow in application than Revenue Ruling 77-316, may achieve some measure of the Commissioner's desired chill upon the use of foreign captives. *Carnation* may be limited in application to circumstances in which an Internal Revenue Service audit discovers agreements by the insured to contribute additional funds to the insurer on demand. It appears unlikely that the Commissioner could have succeeded in *Carnation* without the presence of an agreement which made the

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40. *See* B. Bittker & J. Eustice, note 32 *supra,* § 1.05 (1966).

41. *See, e.g.,* Lowndes v. United States, 384 F.2d 635 (4th Cir. 1967); Noonan v. Commissioner, 52 T.C. 907 (1969), *aff'd,* 451 F.2d 992 (9th Cir. 1971).

42. *See, e.g.,* Aldon Homes, Inc. v. Commissioner, 33 T.C. 582 (1959); *In re* H.G. Prizant & Co. [1969] 2 U.S. Tax Cas. (CCH) ¶ 9592.

43. *See, e.g.,* Kimbrell v. Commissioner, 371 F.2d 897 (5th Cir. 1967); Jones v. Commissioner, 64 T.C. 1066 (1975); Roubik v. Commissioner, 53 T.C. 365 (1969).

44. *See, e.g.,* Raymep Realty Corp. v. Commissioner, 7 T.C.M. (CCH) 262 (1948); Shaw Const. Co. v. Commissioner, 35 T.C. 1102 (1961), *aff'd,* 323 F.2d 316 (9th Cir. 1963).

45. 71 T.C. at 408.

46. *See* note 25 *supra.*

47. 640 F.2d at 1013.

situation in *Carnation* similar to that in *Le Gierse.* Indeed, the application of *Le Gierse* in *Carnation* is, at first blush, correct. Had Mrs. Le Gierse agreed to become liable to her life insurer for some portion of the agreed-upon outlay at its demand instead of paying the entire amount outright, and had the insurer also been a wholly-controlled foreign captive, it seems unlikely that the Supreme Court would have reached a different result. In addition, although *Carnation* in effect achieved the same disregard of the separate corporate identity of related parties achieved in Revenue Ruling 77-316, it cannot be criticized on that ground. As correctly noted by the Tax Court opinion, the similar result in the controlling *Le Gierse* case was reached notwithstanding that the agreements there had been made between separate, unrelated parties.[48] The underpinning of the *Carnation* holding appears to be the presence of the agreement for additional capital contributions to the insurer. The most tenable conclusion is not simply that the separate identity notion is irrelevant to the *Le Gierse* and *Carnation* holdings, but also that neither the foreign-domestic character nor the captive-unrelated nature of the insurer is relevant to the holdings. The *Le Gierse* and *Carnation* principles need not be applied by courts with any more vigor when wholly-controlled foreign captives are at issue than when unrelated domestic insurers are involved.

Whatever the consequence of *Carnation,* the application of *Le Gierse* to the *Carnation* facts cannot be said to be free of error. The Tax Court and the Ninth Circuit unfortunately found the facts of *Carnation* to be nearly identical to those of *Le Gierse* for purposes of applying the risk-shifting test. The facts, however, are distinguishable. Unlike Mrs. Le Gierse, whose life insurance recovery could not have exceeded the $27,125 total payment made to the insurer, Carnation's insurance recovery might well have exceeded the total amount it had paid or was liable to pay Three Flowers. From Three Flowers' point of view, its reinsurance of Carnation's risks was as a casualty policy requiring the insured to bear the first $2,880,000 of loss at the insurer's option. To the extent the insurer might have paid for losses above that amount, it represented a shifting of risks in accord with the *Le Gierse* analysis. Having no section 482 allocation of income argument before them,[49] however, the *Carnation* courts felt constrained to rule upon the entire premium amount rather than the portion repre-

48. 71 T.C. at 408.
49. *Id.* at 412.

senting the excess over the fair market value of the amount of the insurance actually purchased. Instead of approving the Commissioner's position, they should have advised him to present different arguments in future litigation.

JORGE E. ALVAREZ