CAPTIVE INSURANCE TAXES:
Is the Strike Zone Narrowing

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Preview

We are breaking this into three parts:

1) Brief Tax Review

2) Sample IRS Audit Questions

3) Recent captive activity

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A Brief Tax Review

To have a good captive insurance arrangement, one ought to:

1) Have a good business purpose

2) Be in the insurance business (assume and share insurance risk) and

3) Run like an insurance company

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Brief Tax Review (cont.)

The Courts have talked in these terms:

1) Non-tax business purpose
2) An insurance risk
3) Risk transfer
4) Risk distribution
5) Common notions of insurance
6) Not a sham

Brief Tax Review (cont.)

The IRS distinguishes insurance risk from

1) speculative risk (the likelihood of occurrence is too small)
2) no fortuity (the event will inevitably occur, but timing is unknown)
3) business risk
4) investment risk

Brief Tax Review (cont.)

Risk transfer requires the transfer of the financial consequences of a loss to another

- An individual is financially indifferent whether his car wrecks after he buys insurance (and transfers the financial risk to the insurance company)
- This requires that the insurance company have enough capital and that it can pay limit loss(es)

Brief Tax Review (cont.)

- Risk distribution means a pooling of premiums for sufficient risks to allow the law of averages (law of large numbers) to operate.
- The IRS believes that there must be a number of entities in order to be insurance and that a single insured (no matter how large) cannot have insurance if it is the insurance company's only insured.

Brief Tax Review (cont.)

The IRS now agrees risk distribution may take the form of

1) Enough outside business; or

2) Brother-sister insurance

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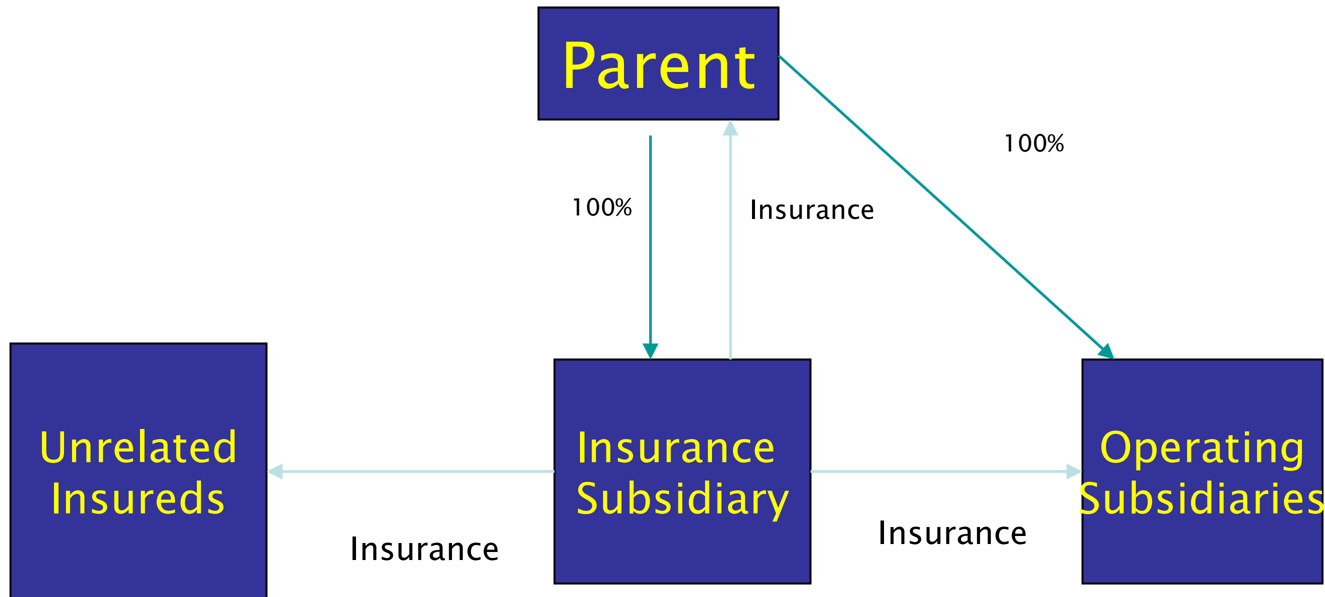
Brief Tax Review (cont.)

Outside Insurance



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Brief Tax Review

Enough Outside Business:

Parent insurance has risk distribution if the insurance company insured sufficient unrelated business:

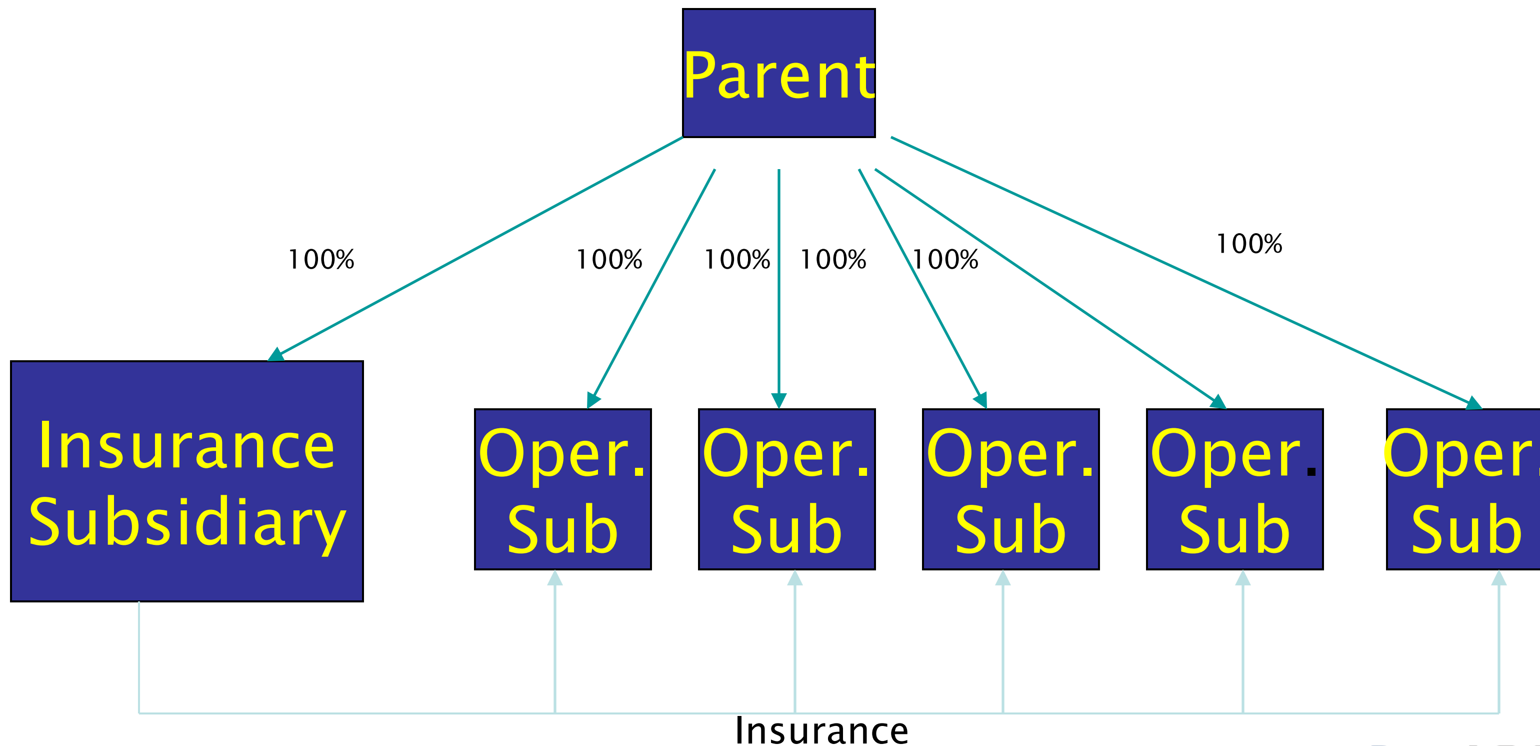
1) The IRS says 50% is enough and 10% is not enough

2) Harper Group case says 30% is enough

The IRS has asked whether it matters if the related and unrelated business are the same coverage

Brief Tax Review (cont.)

"Brother-Sister" Insurance



Brief Tax Review (cont.)

"Brother-sister" insurance

- There is risk distribution where a captive sells insurance to enough operating subsidiaries (who own no stock in the captive)
- The IRS says that if there are 12 subsidiaries all with between 5% and 15% of the risks, there is insurance.
- The IRS says that when there is only one insured (or 2 with one having 90% of the risk), there is no insurance, even in an unrelated context.

Brief Tax Review (cont.)

- The IRS believes that a single-member LLC that is “disregarded” is not an insured (its owner is); but, if the LLC has “checked the box” to be a corporation, the LLC is the owner.
- The IRS has also stated that a multi-member LLC is the insured (and that the owners are not the insureds).
- The IRS further stated that the general partner(s) of a limited partnership is the insured, and not the limited partnership or the limited partners.

Sample IRS Audit Questions

- Tim Collins was the IRS Captive Industry Specialist who was consulted by IRS auditors if they saw a captive insurance company during an audit. He retired in January 2009. His role has been assigned to one of the two Industry Specialists for all insurance companies.
- The following set of questions were posed by Tim Collins during a panel presentation with Tom Jones as sample questions during an IRS audit and published by the Hawaii Captive Insurance Association.

Sample IRS Audit Questions

1. Was a feasibility study performed showing business benefits? The IRS is more likely to "find an adjustment" with a taxpayer that does not follow good business practice.
2. Assess whether the assuming company has the capacity to assume the risk. Look at the premium to surplus ratio. Are there any parental guarantees? What is the maximum single risk exposure compared to surplus?
3. Consider whether the risks are garden-variety insurance risks or unique risks that require further investigation into whether the risks are insurance risks.

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Sample IRS Audit Questions

4. Consider whether the insured is in substantial part paying for its own losses, by comparing the relationship of the largest insured as measured by premiums to total premiums.
5. Consider whether there are sufficient exposure units for risk to be reasonably predictable (law of large numbers).
6. Assess whether the Captive is operating as an independent entity and whether there is insurance in its generally accepted sense. Part of this is the question is could the Captive still function if its largest investment failed?

Sample IRS Audit Questions

7. Is there a loss portfolio transfer and is there a significant chance of a significant loss as required for GAAP under FASB 113?
8. If parent premiums are deducted, determine whether there is a sufficient amount of unrelated risk assumed by the Captive.
9. Is the taxpayer taking a consistent position by paying excise tax for risk ceded to an offshore insurance company that is not taxed as a U.S. taxpayer?

Sample IRS Audit Questions

10. Did the Captive enter into a finite risk contract with an offshore reinsurance company that is a non-Controlled Foreign Corporation? If so, review the transaction to determine whether there is significant tax avoidance.

11. Are Captive assets used as security or as a compensating balance for the liabilities of another entity?

Recent Captive Activity

- In 1977, the IRS said captive insurance was not insurance, no matter how it was structured.
- In 2001, the IRS conceded that captive insurance "works," if done correctly.
- In 2002, the IRS published some "safe harbors."
- Since then, the IRS has been "narrowing the strike zone."

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Recent IRS Statements

- Since May 2008, the IRS, Congress and President Obama have all commented on captives or items that may affect captive insurance.

- This indicates that captives should continually monitor their operations against the ever-evolving tax standards.

501(c)(15) Audits

- Section 501(c)(15) captives are those which are completely exempt from all Federal income tax (not just the tax on underwriting income). The law changed in 2004 to make it more difficult to qualify for this tax exemption.
- The IRS has developed a "project" to systematically audit section 501(c)(15) captives for years prior to the law change
- The IRS has publicly retroactively revoked or denied the exemption of about a dozen organizations and denied reliance on the tax exemption letter it issued

Arguments Raised in 501(c)(15) Audits

- No employees to solicit insurance business
- No employees to conduct the insurance business
- Little time devoted to
  - Insurance products development
  - Marketing insurance
  - Insurance activities
- Capital and efforts were not used to conduct insurance operations
- Too many assets for size of insurance operations (e.g., surplus is 90 times the amount needed to write the insurance program)

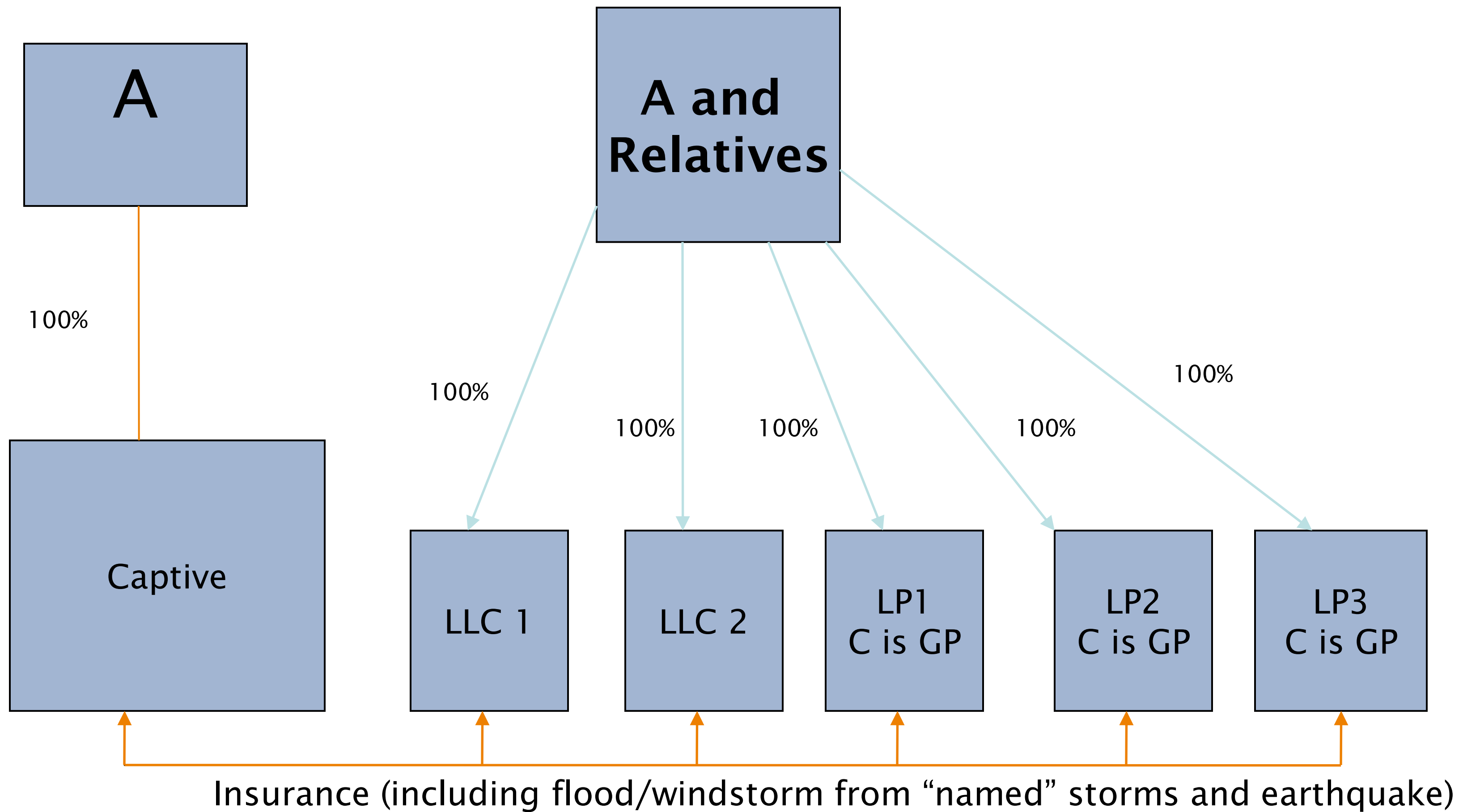
Arguments Raised (cont'd)

- Investment company not insurance company
- Insurance is not the primary and predominant business (e.g., less than half the income is premiums; subjective test pre-2004)
- Lack of homogeneous risks (e.g., 12 policies issued to two insureds for 10 different types of insurance)
- Minimal reserves
- No claims
- Too few insureds or otherwise no risk distribution

Arguments Raised (cont’d)

- Not run like an insurance company
- No attempt to meet insurer’s capital requirements for captive to reinsure the insurer
- No premium income
- Premium received from only one insured and not allocated to other insureds
- “Additional insureds” were not really insureds
- “Run off” delayed to take advantage of tax exemption

501(c)(15) Revocations – 200952060 and 200952061



200952060 and 200952061 (cont'd)

- A owns 100% of a captive
- A and B (a relative) own C, the General Partner of 4 to 8 limited partnerships
- A and relatives own two LLCs

The captive insures the LLCs, limited partnership and the owners for, among others, flood/windstorms from named storms and earthquakes, all but one are located in some geographic area.

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200952060 and 200952061 (cont'd)

The IRS revoked the tax exempt status of the captive because it was not an insurance company.

- Who is an insured – the IRS followed TAM 200816029:
  - Multi member LLCs are insureds
  - Each General Partner of a Limited Partnership is an insured (but the entity is not an insured)

200952060 and 200952061 (cont'd)

Concentration of Risk

- In these revocations, two or three entities had the great bulk of the risk (the precise numbers were redacted)
- Rev. Rul. 2005-40 ruled that there is no insurance between unrelated parties when there is either only one insured or two insureds, if one represents 90% of the risk.

200952060 and 200952061 (cont'd)

- Rev. Rul. 2002-90 found risk distribution present where there were 12 subsidiaries, none of which had less than 5% nor more than 15% of the captive's risks, the captive had a significant volume of independent, homogenous risks and the remaining facts were "plain vanilla."

200952060 and 200952061

<u>Independent Risks</u>. Because a "named" storm or earthquake would likely damage all property in the same geographic area, the risks were not independent. The IRS had previously ruled that there could not be flood insurance for those in the same floor plain. Each insured was essentially paying its own losses.

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501(c)(15) Revocation – CCA 201015043

- “Usual” concerns
- Investment activities greater than insurance activities
- Substantial related party loans, some of the loans had a zero interest rate

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Pooling

- One way to insure third-party risks is to participate in “pools.”
- While pools represent an established mechanism to insure unrelated risks, there was not much authority addressing their tax treatment until the last few years.
- None of the authority is precedential.

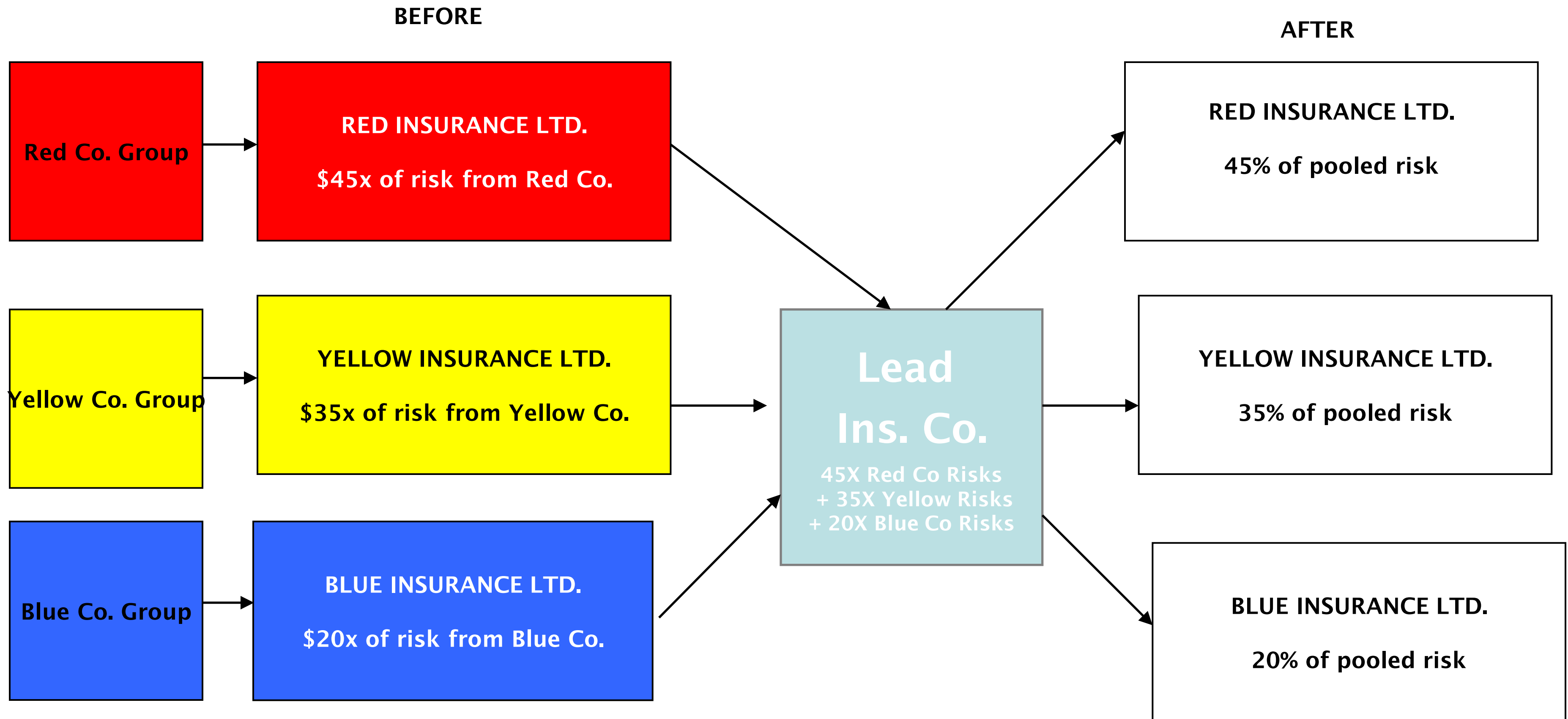
PLR 200907006

- PLR 200907006 involves a 100% pool.
- A group of related insureds insured with a captive.
- That captive and 5 other unrelated captives reinsured 100% of their risks with "Lead Insurance Company," which in turn re-reinsured a proportionate part of the risks to each captive.
- Each captive insured a part of the risks of at least 12 insureds, none of which was more than 15% of the insured risks.

PLR 200907006 (cont'd)

- The IRS found insurance and cited the group captive ruling, although it seems the "unrelated business" ruling applied
- The next slide illustrates the concepts, but not the facts, of the PLR

PLR 200907006 (cont'd)

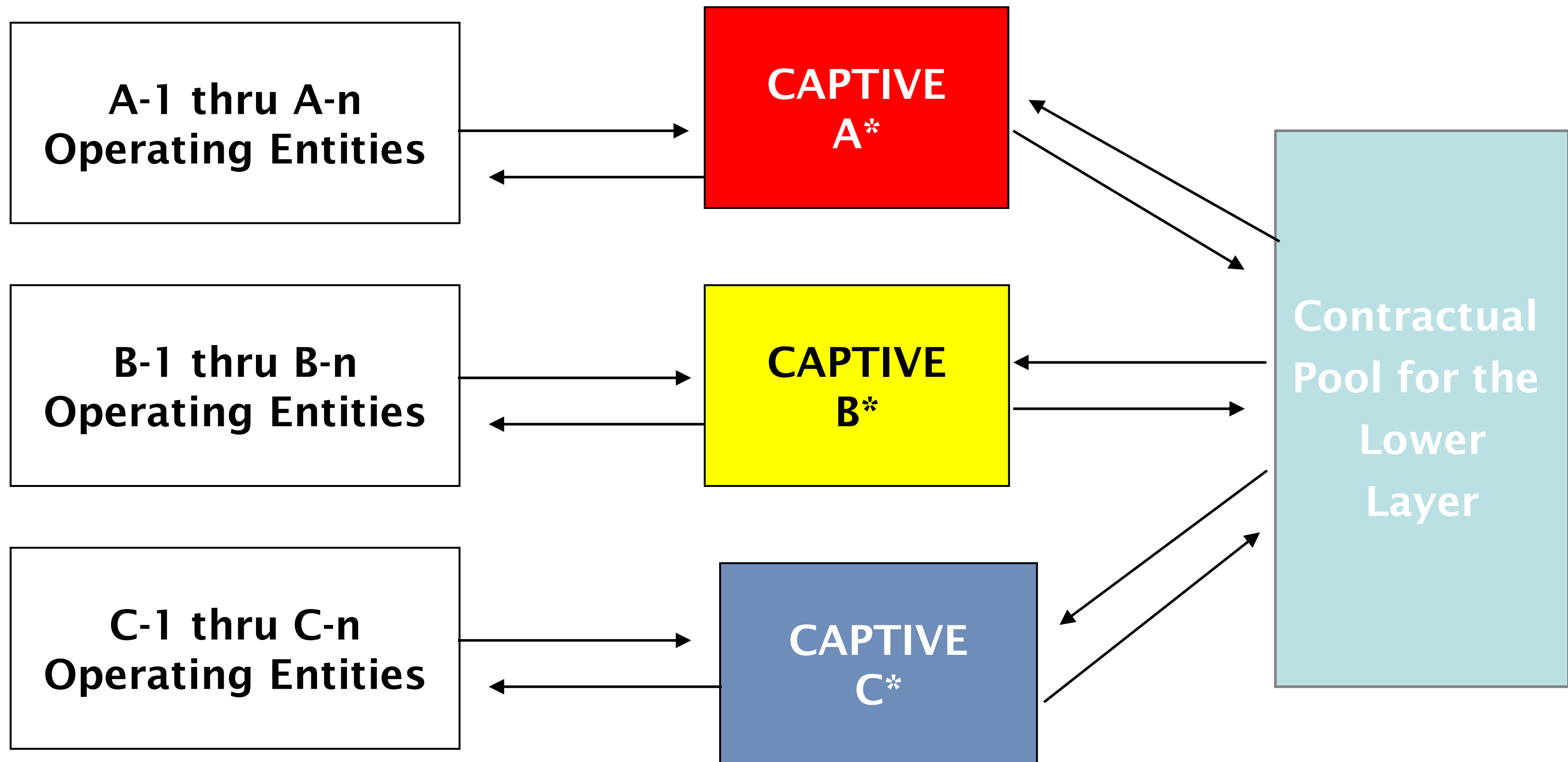


This slide illustrates pooling, but does not address the number of insureds or insurers needed for sufficient risk distribution.

Pooling (con't.)

- ILM 200844011-
  - A group of operating entities insured the first $250,000 of liability with a related captive
  - The captive retains the level between $100,000 and $250,000
  - The captive (and similar captives) pool risks between 0 and $100,000 contractually
  - The ILM concluded the contractual pool is a foreign insurance company and excise tax is owing
  - This conclusion would not have been reached if the pool were not insurance

Pooling (con't.)



*Retain Upper Layer

This slide illustrates pooling, but does not address the number of insureds or insurers, more maximum percentage risk, needed for sufficient risk distribution.

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PLRs 200950016 and 200950017

- Unrelated groups of insured in the same industry insured three layers of coverages with a fronting company.
- The fronting company retained the upper layer and reinsured the lower and middle layer to Reinsurer A.
- Reinsurer A retained the lower layer and reinsured the middle layer to Reinsurer B.
- Reinsurer B reinsured a pro-rata portion of the middle layer to captive insurance companies owned by owners of the respective insured groups.

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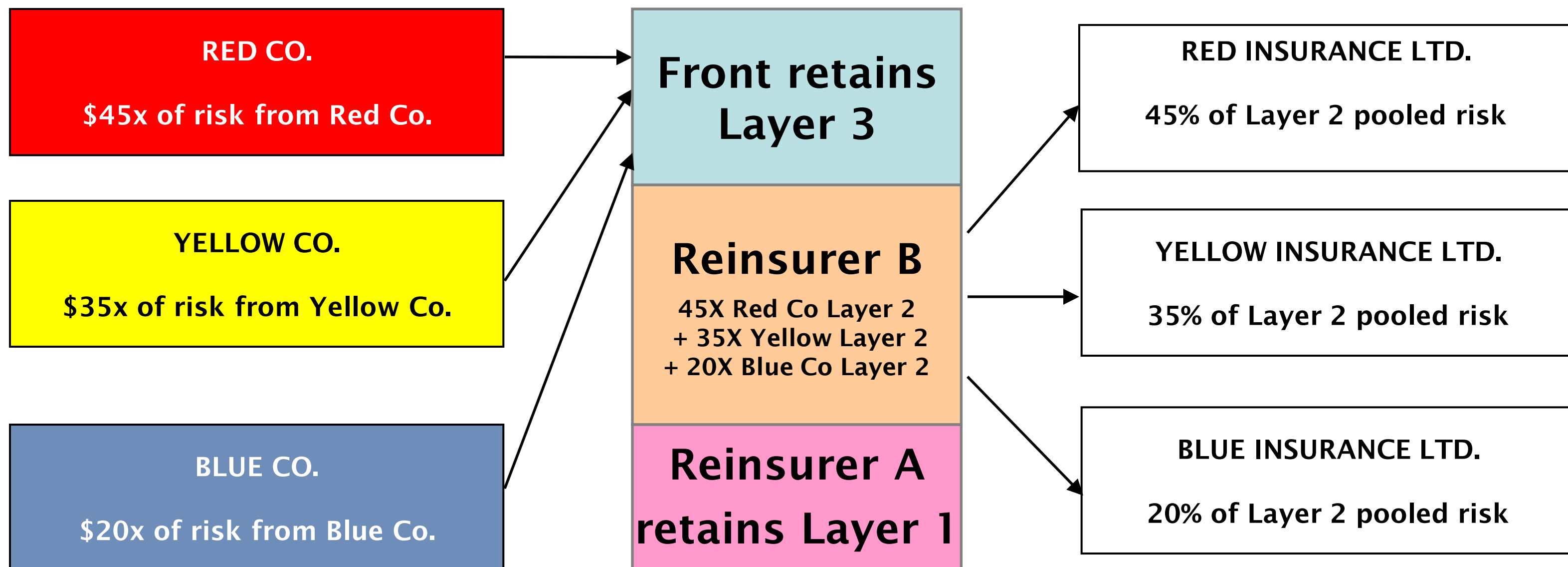
PLRs 200950016 and 200950017 (cont'd)



This slide illustrates pooling, but does not address the number of insureds or insurers needed for sufficient risk distribution.

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Can There Be Only One Reinsured?

- Rev Rul. 2005-40 ruled that there could never be insurance if there were only one insured (no matter how many risks were insured).
- The question arises whether a captive that reinsures one fronting company in one insurance contract is viewed as insuring only one insured (and thus the arrangement is not treated as insurance for tax purposes), or is treated as effectively insuring the underlying insured.

Rev. Rul. 2009-26

- The industry believes that in determining risk distribution on a reinsurance contract one looks through to the risks of the ultimate insureds on the underlying (primary) insurance contract.
- Rev. Rul. 77-316 ruled similarly before it was revoked.
- Rev. Rul. 2009-26 confirmed this is the case.
- It discussed two situations.

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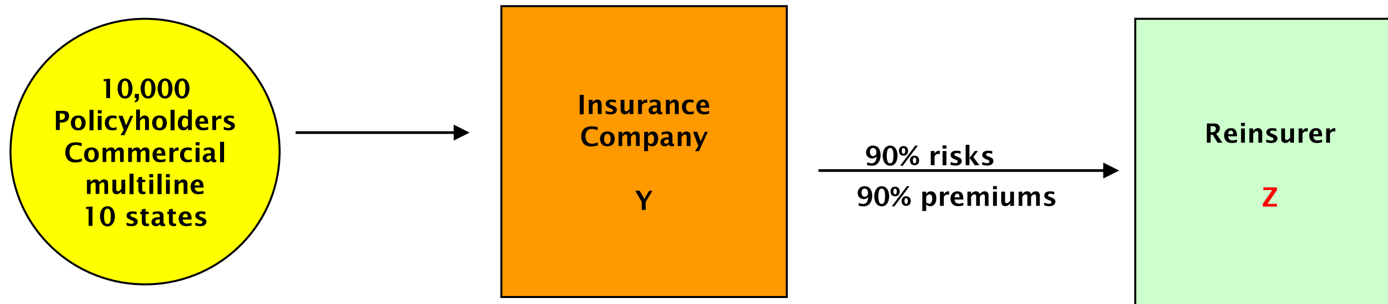
Rev. Rul. 2009-26 (cont'd)

Situation 1 of Rev. Rul. 2009-26



- Z operates at arms length with Y
- Z operates in accordance with state law
- Ruling: Z has risk distribution as if it had insured 10,000 policyholders directly
- Z is adequately capitalized

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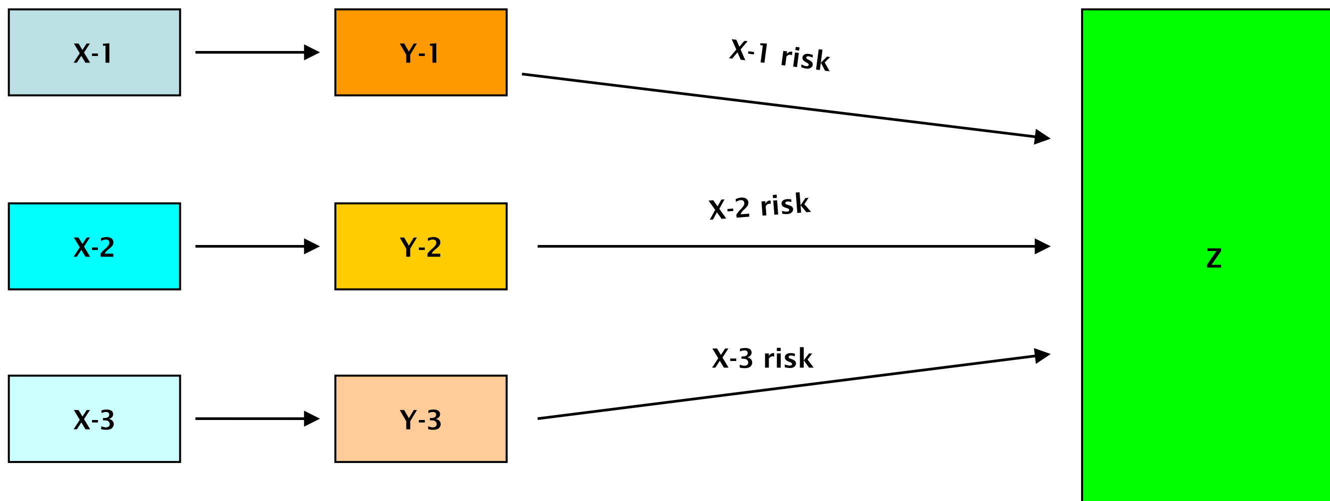
Rev. Rul. 2009-26 (cont'd)



- Assume each "X" operating company is one of many insureds of its respective "Y" insurance company
- Only risks of each "X" are reinsured with Z. All risks are the same risk in the same line of business
- Had Z insured each of the "X" entities directly, it would have qualified as an insurance company
- Ruling: Z is an insurance company

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Recent IRS – Cell Taxation

- In 2005, the IRS asked the industry how to tax cells.
- The industry responded, but it took the IRS 2 ½ years to issue its position, which it did in two parts.
- For determining if a transaction is insurance <u>and</u> if the insured gets a tax deduction, insurance is tested on a cell-by-cell basis.

Recent IRS – Cell Taxation

- This means that the cell has to have risk distribution (enough insureds or enough outside business) within its own walls and it cannot rely on the mere fact that cell owners are unrelated, unless it shares in other cells' risks.
- Everyone assumed this would be the IRS rule

Recent IRS – Cell Taxation

- For the taxation of the cell and the entire cell company, the IRS:

  1) proposed a set of rules, but did not finalize them; and

  2) said they would not be effective for at least a year after they are finalized

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Recent IRS – Cell Taxation

As currently proposed, each cell:

- Is its own insurance company (if it sells insurance)
- Makes it own elections (for example, 953(d) and 831(b))
- Gets its own Federal ID number
- See CCA 200849013 discussed below under homogeneity, the National Office assumed a cell was a separate entity.

Comments

- The IRS solicited comments as to how cell taxation should work and how it should be transitioned
- The comments did not argue against the IRS proposed approach
  - Transition rules should be liberal and restructuring flexible
  - Incorporated cells should be approved immediately
  - One set of comments addressed the taxation of non-insurance cells

IRS 2009–2010 Business Plan

- "Guidance concerning the classification of series LLCs and cell companies under § 7701."
- "Guidance on the classification of certain cell captive insurance arrangements. Previous guidance was published in Not. 2008-19."
- "Revenue ruling providing guidance on reinsurance agreements entered into with a single ceding company." (Issued as Rev. Rul. 2009-26)

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Recent IRS – Cascading of Excise Tax

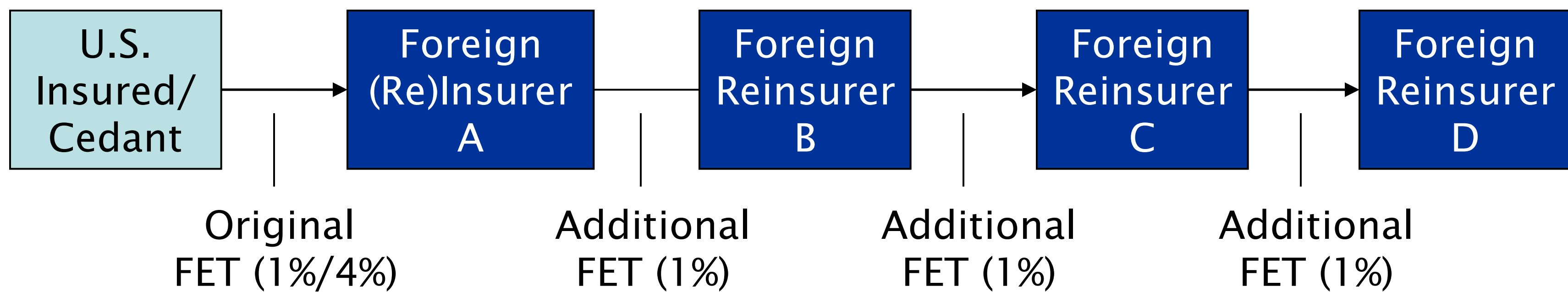
- This will generally have no effect on a lot of captives, but it underscores the IRS expansive views and actions.
- The items described below come from the International Branch, not the Insurance Branch.

Recent IRS – Cascading of Excise Tax (cont.)

- A excise tax of 4% of premiums is imposed on most direct P&C insurance of U.S. risks insured by a foreign insurer (not doing business in the U.S., not having elected to be taxed as a U.S. insurance company and not protected by a tax treaty). The rate is 1% of reinsurance premiums on U.S. P&C risks, direct life, sickness and accident insurance and annuities, insured by a foreign (re)insurer.

Revenue Ruling 2008-15

- In Rev. Rul. 2008-15, the IRS announced that it will impose an excise tax on every subsequent reinsurance transaction.



- Rev. Rul. 2008-15 sets forth four situations to demonstrate this principle with and without applicable tax treaties.

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Cascading of Federal Excise Taxes

- IRS Announcement 2008-18 states that the IRS will not seek to collect the cascading taxes for periods prior to October 1, 2008 from insurance companies that agreed to collect such taxes at all times on or after October 1, 2008.
- If an insurance company does not agree to do so, then the IRS feels free to seek to collect those taxes for all periods.

Excise Tax – Audit Technique Guide

- In September 2008, the IRS issued its Foreign Insurance Excise Tax – Audit Technique Guide
- It is to be used by International Income Tax Agents in audits of excise tax on insurance premiums
- Chapter 7 discusses cascading tax on successive premiums
- Chapter 6 discusses captive insurance

Homogeneity

- The IRS uses 50% of outside business as its safe harbor
- In IRS Notice 2005-49, the IRS has asked for comments on the significance of "homogeneity."

Homogeneity (con't.)

- Both the CICA and VCIA comments on homogeneity in response to IRS Notice 2005-49 state that homogeneity is not required in order to have insurance and that heterogeneous risks are sometimes preferred.
- In CCA 200837041 – the Taxpayer's section 501(c)(15) tax exempt status was revoked, in part, because it had twelve policies of ten different types for two insureds.

Homogeneity (con't.)

- CCA 200849013 – Taken as a whole, the insurance program insured sufficient "brother-sisters," after relaxing the 15% standard a little.
- If insurance were tested on a line-by-line basis, at least some lines would not be insurance (e.g., one insured).
- The National Office refused to take a position on homogeneity.
- It allowed the Examination Division to determine if homogeneity is relevant.

Offshore Interest

- President Obama and Congress have expressed interest in offshore activities

- Senator Carl Levin has once again introduced the "Stop Tax Haven Abuse Act" (co-sponsored by then Senator Obama in 2007)
- Representative Neal has again introduced legislation aimed at related party reinsurance. It is not aimed at captives, but could affect some captives.

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831(b) elections

- Plr 201105020 – provided the case where a taxpayer failed to make the election with its timely filed federal income tax return.
- Taxpayer’s failure was due to the accountant’s error
- Service granted relief

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Recent ruling Activity

- Soon to be released PLR related to what happens when an insurance company no longer qualifies
- Company believed itself to be insurance
- Accountants determined that certain facts were not the case and as a result Company no longer qualified as an insurance company

Recent Activity

- Company filed form 3115 with the insurance branch for both the insurance company and the insured
- Service split the request and insurance sent it to deductions branch and income branch
- We requested that they be viewed together, service said no they are distinct and separate taxpayers

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Recent Activity

- Deductions group agreed with the request
- Income group did not believe that the amounts paid to the insurance company were deposits
- They wanted to treat it as service fee income; as many of you know this is the result we have discussed many times before
- Tentative result was insured was not going to get a deduction for payments and the insurance company was going to have to pick up income

Recent Activity

- Upon appeal of the initial ruling, the service finally concluded that the payment was in fact a deposit and not taxable to the insurance company
- Insured will be a allowed a deduction on the actual payment of a loss and the insurance company will only recognize income on investments

Future Issues?

- Insurance Risk
- Homogeneity
- Loan Backs
- Finite Insurance
- Risk Distribution
- Sufficient Exposure Units?
- Catastrophic Coverages
- Retroactive Insurance
- Section 831(b)
- State Tax