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Please contact the following attorneys if you have any questions about this decision or want additional information regarding insurance law matters:

Kevin G. Fitzgerald
414.297.5841
kfitzgerald@foley.com

Richard Bromley
312.832.4517
rbromley@foley.com

Ethan D. Lenz
414.297.5835
elenz@foley.com

Benjamin S. Thomas
414.319.7329
bthomas@foley.com

The Death, by Taxes, of the Pure Captive

Introduction

The tax treatment of captive insurance companies, and their affiliates, has long been a "battle" between taxpayers and the Internal Revenue Service ("IRS"). Originally, the battle focused on whether the transaction at issue constituted "insurance". Having to a large extent lost that battle, the IRS is taking a different approach, which if successfully adopted, will have the same ultimate effect of denying the desired tax treatment for many captive arrangements.

Background

Under the definition set forth in *Helvering v. Le Gierse,* 312 U.S. 531 (1941), risk shifting and risk distribution are the primary requirements for insurance. Beginning in 1977, the IRS adopted the "economic family" theory, under which a parent corporation and its subsidiaries do not shift risk or distribute risk to an affiliated captive if the ultimate burden of loss is retained by the same economic family that may suffer a loss. As a consequence, the IRS concluded that "when there is no economic shift or distribution of the risk 'insured,' the contract is not one of insurance, and the premiums therefore are not deductible under section 1.162-1(a) of the regulations." Since the premium payments were not treated as payments for insurance, they were capital contributions. Moreover, the related captive insurer was not treated as an insurance company if its primary and predominant business activity was insuring or reinsuring the risks of related parties. In sum, the IRS maintained the position that there can be no risk shifting or risk distribution unless the economic burden of loss is transferred outside the economic family. The IRS's economic family theory was never adopted by the courts, and the IRS finally abandoned it on June 5, 2001.

On December 11, 2002, the IRS issued three new revenue rulings on the qualification of captives as insurance companies for federal tax purposes. These rulings focus on risk shifting and risk distribution under parent-subsidiary, brother-sister, and group captive insurer arrangements. For a more detailed discussion of these rulings, please see, "Non-Profit Health Care System Captives: Is Your Captive an "Insurance Company" and Do You Want it to Be?" These rulings provided affirmative guidance to taxpayers on how to meet the risk shifting and risk distribution requirements for insurance, and have been extensively relied upon by taxpayers in setting up their captive insurance programs.

Proposed Regulations

On September 27, 2007, the IRS issued proposed regulations regarding captive insurance companies that will fundamentally change the tax situation for pure captives. Rather than challenging the issue of whether the transaction is insurance, or whether the captive is an insurer, the IRS instead is modifying the intercompany obligation regulations. In summary, if a captive insurer is part of a consolidated tax group with the insured (or reinsured), the new intercompany obligation regulations will negate any acceleration of deductible losses.

Under current tax rules, assuming the transaction qualifies as insurance, the taxpayer/insured deducts the premium paid to the affiliated captive insurer. The captive insurer accordingly has reportable income, but is allowed, as an insurance company, to establish (and deduct) unearned premium and loss and expense reserves. Thus, current premiums are deferred and taken into income over the term of the policy, and future loss payments are effectively accelerated into the current tax year by the establishment of these reserves. This tax treatment is predicated on the transaction being taken into account on a "separate entity basis."

Under the proposed regulations, the IRS is doing away with the separate entity approach, and instead is requiring the transaction to be accounted for on a single entity basis. Therefore, the taxpayer/insured can still deduct the premium. However, while the affiliated captive insurer's income from the transaction will be taken into account currently, the captive will not be allowed to recognize the remaining effects of the intercompany transaction (i.e., the deductibility of loss and expense reserves) on a current basis, resulting in the transaction effectively being treated in a manner comparable to "self-insurance" by a single corporation. In other words, the captive insurer will be required to recognize premium income "upfront," but will only be allowed to take a deduction when the loss and related expense are paid (not when it is accrued for).

These proposed intercompany obligation rules, if adopted, will apply any time a captive insurer receives 5 percent or more of its total premium from affiliates within the same consolidated tax group. In other words, in order to avoid this tax treatment, more than 95 percent of the premium received by the captive insurer must relate to risks outside of the group! Further, any use of reinsurance transactions (i.e., a fronting company for example) to circumvent the single entity rules may be subject to the anti-avoidance rules of Section 1.1502-13(h) and Section 845.

The proposed regulations will apply to intercompany insurance transactions occurring in taxable years beginning on or after the date on which the regulations become final. Prior to the regulations becoming final, taxpayers may continue to rely on existing authority. The proposed regulations provide for a comment period that extends through December 27, 2007. It is therefore unlikely that final regulations will be promulgated before 2008. Hence, the regulations should not apply to intercompany insurance transactions entered into prior to taxable years beginning on or after some date in 2008.

Conclusion

While the IRS was never very successful challenging the insurance nature of most captive insurance arrangements, its latest attempt will, if adopted, likely have the same effect. Namely, there will be no tax advantages to establishing a captive arrangement over the use of simple self-insurance. While there may very well be other advantages (or needs) to use a captive, the tax advantages will be largely eliminated.