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IRS Issues Ruling Regarding Taxation of Protected Cell Companies and Requests Comments on Implications

The Internal Revenue Service (IRS) recently issued guidance on the standards for determining whether protected cell captive arrangements constitute insurance for federal income tax purposes.[1] Rev. Rul. 2008-8. At the same time, it requested comments on further guidance concerning issues that arise if such arrangements do constitute insurance. IRS Notice 2008-19. The current ruling is a follow-on to Notice 2005-49, in which the IRS requested comments on how best to determine whether cell captive arrangements constitute insurance.

The Cell Captive Ruling

Bottom line, Revenue Ruling 2008-8 extends the reach of a series of earlier revenue rulings in which the IRS articulated standards for determining whether payments to a captive qualify as "insurance premiums" for tax purposes. These rulings concluded that:

1. Payments in single-parent captive arrangements, in which the only risks assumed by the captive are those placed by the parent of the captive, do not constitute "insurance premiums;"[2]
2. Payments in brother-sister affiliate arrangements, in which only a small portion (from five to 15 percent) of the captive's total risk is from any one affiliate of the captive, do constitute "insurance premiums;"[3] and
3. Payments in group captive arrangements, in which a small group of unaffiliated companies form a captive, also constitute "insurance premiums."[4]

Revenue Ruling 2008-8 concludes that a determination of whether a captive cell arrangement may be treated as "insurance" for tax purposes turns on whether the cell fits into the single-parent and subsidiary mold, or into the brother-sister affiliate mold. This determination is made on a cell-by-cell basis — whether a transaction with a particular cell is treated as insurance has no bearing on whether transactions of each of the other cells in the protected cell company are treated as insurance.

[1] A protected cell company is an entity formed under a state-protected cell statute that establishes multiple cells or accounts. Each cell has its own participant and name, but is not treated as a legal entity distinct from the protected cell company under state law. The cells are funded by their participants' capital contribution and "premiums" for contracts between the participants and the cells. The assets of a particular cell are protected from the creditors of the other cells as well as the creditors of the protected cell company.

[2] Revenue Ruling 2002-89.

[3] Revenue Ruling 2002-90.

[4] Revenue Ruling 2002-91.

When the only risks placed with a cell are those of the cell's shareholder parent, the arrangement lacks the elements of risk shifting and distribution necessary to qualify as insurance. As such, the cell's parent-participant is not entitled to deduct the premiums it pays to the cell.

Conversely, when a cell takes on the risks of multiple brother-sister affiliates (in the example in Revenue Ruling 2008-8, there are 12 brother-sister corporations), the arrangement is deemed to involve risk transfer and risk distribution. Contracts between such a cell and its affiliates are thus "insurance contracts" and allow the insured affiliates to deduct their premiums.[5]

The Notice and Request for Comments

As noted above along with Revenue Ruling 2008-8, the IRS issued Notice 2008-19, which includes proposed guidance and requests comment on issues that arise if arrangements between a cell and its participant are seen as "insurance." The proposed guidance would include a rule to the effect that for federal income tax purposes, a cell of a protected cell company would qualify as an insurance company separate and apart from any other company (including the protected cell company) if:

- Its assets and liabilities are segregated from those of other cells and of the protected cell company, so that creditors of other cells or the protected cell company may not look to the assets of the cell for satisfaction of any liabilities, including insurance claims (except to the extent that another cell or the protected cell company has a direct creditor claim against the cell).
- Based on all the facts and circumstances, the arrangements and other activities of the cell, if conducted by a corporation, would result in its being classified as an insurance company for federal income tax purposes. The activities of a cell that qualifies for treatment as an insurance company for tax purposes would be disregarded in determining the tax status of the protected cell company as an insurance company.

Notice 2008-19 also requests comments on such matters as:

- Transition rules that would be appropriate for the protected cell company and cells of such companies in which a cell qualifies as an insurance company for some taxable years, but not for others.
- Any reporting that would be necessary on the part of individual cells.
- Whether special rules should apply with respect to foreign entities.
- Proper treatment of protected cell companies and their cells under rules regarding consolidated returns. Comments are due 90 days after Notice 2008-19 is published in the Internal Revenue Bulletin.

[5] Revenue Ruling 2008-8 comes on the heels of the IRS's recent proposed regulations issued on September 27, 2007. These proposed regulations essentially state that if a captive insurer is part of the same consolidated tax group as the entities it insures, the captive insurer will not be treated as an insurance company for tax purposes. Thus, if the IRS adopts the proposed regulations of September 2007, transactions with cells that comply with Revenue Ruling 2008-8 (brother-sister affiliate arrangements) and otherwise qualify to be taxed as insurance companies, may nonetheless be subject to the restrictions of those proposed regulations. Notice 2008-19 specifically requests comments concerning proper treatment for consolidated return purposes. For a more complete analysis of the September 2007 proposed regulations, please see the article, "The Death, By Taxes, Of The Pure Captive."

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