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IRS Withdraws Controversial Proposed Regulations

On February 19, 2008, the Internal Revenue Service (IRS) commuted the potential death sentence that it had imposed on the pure captive insurance industry by withdrawing its highly-controversial proposed regulation of September 28, 2007. The proposed regulation (REG-107592-00) would have disallowed separate entity treatment for insurance transactions where five percent or more of a captive insurer's business (measured by its premium volume) consisted of insuring risks of other members of the captive insurer's consolidated group. Where this modicum of related company business existed, the tax accounting rules normally accorded insurance transactions would have been largely eliminated. The proposed regulations made the use of a pure captive no more advantageous, from a tax standpoint, than the use of self-insurance.

While the IRS's announcement of February 19, 2008 may bring a sigh of relief from those currently utilizing a pure captive arrangement (or those that are interested in doing so in the future), the announcement should not be seen as the definitive end of the deliberations over the taxation of captive insurance companies. The

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IRS will continue to study whether rule changes need be made to “clearly reflect the taxable income of consolidated groups” (RIN 1545-BA11). It seems doubtful, however, that the draconian measures of the proposed regulation will be resurrected.