Captive Insurance: Considerations in Taxation
Overview

- Captive Overview
- Benefits of Insurance Company Treatment
- Shareholder Tax Implications
- Qualifying as an Insurance Company
- Insurance Risk
- Risk Shifting and Distribution
- Internal Revenue Service ("IRS") Views on Captive Arrangements
- Impact of Third Party Risks on Captives
- U.S. Taxation of Foreign Domiciled Captives
- Cell Companies / Segregated Portfolio Companies / Portfolio Insurance Companies
- Recent Developments / International Reporting Standards
- Tax Compliance
What is a Captive?

- A closely held insurance company whose insurance business is primarily supplied and controlled by its owners.
- Generally, the risk that is insured through the captive organization is also a “captive risk” (i.e., a risk of the owners or of affiliated organizations).
- Generally, the original insureds are the principal beneficiaries.

Given the 60+ year history of captive insurance arrangements, multiple variations have surfaced that have broadened the definition of captives over time.
Categories of Captives

- **Single-Parent Captives** – also called “pure” captives. Generally, pure captives insure only risks of the owner or affiliated organizations. Many are formed to provide a single type of insurance for the parent or affiliates, such as property insurance or workers’ compensation.

- **Group Captives** – have multiple owners or sponsors. Generally formed to insure the risks of the group of shareholders and/or their affiliates.

- **Risk Retention Groups** – Created under federal law to avoid regulation in every state. Requires at least two members and can only provide liability coverage (all liability except workers’ compensation).

- **Protected Cell Companies (“PCCs”)** – Captive is often owned by a sponsor that allows third party insureds to benefit from the captive’s infrastructure and “rent” a “cell” from the captive for purposes of placing their risks in isolation from the risks of other cells and the sponsor’s “core”.

- **Reinsurance Pools (e.g., Section 831(b))** – grouping of insurers that provide partial or complete insurance coverage to other insurers for a risk on which a policy has already been issued.

- **Insurance Linked Securities** – financial instruments whose values are driven by insurance loss events and issued to provide insurance/reinsurance projection to insurer (e.g., catastrophe bonds).
Types or risk covered by Captives

- **Traditional**
  - Deductibles and self-insured retention programs
  - Directors & Officers or General and other professional liability
  - Product Liability
  - Vehicle insurance
    - Extended coverage
    - Corporate Fleet insurance – property damage and 3rd party liability
  - Workers’ Compensation
- **Non-traditional or newer coverage**
  - Longevity risk (pension plans)
  - Stop loss for self insured health plans or other types of medical insurance
  - Cyber-liability
  - Kidnap and ransom
  - Terrorism or acts of war
Benefits of a Captive

A properly structured captive insurance arrangement may provide numerous benefits from an operational and business perspective.

Operational Benefits:
- Expense reduction leading to improved cash flow (e.g., reduced cost of coverage)
- Centralized management of risk within an organization
- Minimizing capital requirements to fund certain risk exposures through pooling of risks
- Capital deployed to reserve against losses is invested in an efficient manner consistent with overall organizational goals and policy
- Flexibility in insurance policy design
- Creation of a profit center for accepting profitable third-party insurance business
- Reduction or elimination of the self procurement tax
- Creation of a vehicle to move funds within an organization in a tax-efficient manner (and the focus of the rest of this presentation)
Benefits of a Captive

• Business Benefits:
  – Direct access to reinsurers
  – Access to TRIA
  – Provision of broader or otherwise unavailable coverage
  – Certification of Insurance Coverage
  – Mitigation of the market swings of commercial insurance
  – Predictable costs at the subsidiary level
  – Spreading of risks among affiliated groups
  – Improved risk retention capability
General overview of tax matters

• Key question for all stakeholders is – Does the Captive arrangement qualify as insurance under the Internal Revenue Code (“IRC”)?
• From the Captive’s perspective
  – Understanding federal income tax computations (e.g., taxable income, earnings & profits, deduction of loss reserves)
  – Understanding the application of federal excise taxes
• From the insured’s perspective
  – Understanding if the premium payments are deductible for U.S. tax purposes
  – Understanding if any other taxes or fees may be attached (e.g., foreign income or withholding taxes, state direct/independent/self-procurement taxes)
• From the owner’s perspective
  – Understanding tax implications of capital contributions, letters of credit, distributions, “inclusions”
• An insurance entity that qualifies as an insurance company is taxed under Subchapter L of the IRC.
• Accelerated deductions allowed under IRC §832(b)(5) and IRC §846 which allow insurance companies to set-up and deduct a portion of their reserves for unpaid claims, including:
  – “IBNR” (Incurred but not reported),
  – Case reserves
• Deferral of income recognition allowed under IRC §832(b)(4)(B) which generally allows insurance companies to reduce recognition of collected but unearned premium income to 20% (80% deferral on unearned premium reserves).
• Insurance companies are eligible to make specific elections under IRC §831(b) to be taxed solely on investment income and under specific facts may qualify as tax exempt under IRC §501(c)(15).
• Captive insurance companies which are foreign domiciled and qualify as insurance companies under the IRC as well as Controlled Foreign Corporations ("CFC") are eligible to make an election under IRC §953(d) to be treated as a U.S. domiciled corporation for all purposes of the IRC.

• Premiums paid to a foreign insurance company, including a captive company, which has not made a 953(d) election will be subject to Federal Excise Tax
  – Excise tax is 4% on direct written premium or 1% of reinsured premium

• Domestic captives liable for applicable State premium tax. In general, Captives available for / subject to “in lieu” provisions at State level, thus subject to premium taxes in lieu of income taxes
General overview of tax matters
Insured’s perspective

- An insured that pays a premium to an insurance company that qualifies as such under the IRC will be able to deduct the premium paid as an ordinary business expense under IRC §162
- Deductibility of premium payment is preferred versus deductibility under a self-insured approach which is generally restricted to deductibility as claims are incurred and claim payments are made
- Other tax implications may include
  - Liability for federal excise taxes, if applicable
  - Liability for state premium taxes, if applicable
  - Liability for self procurement taxes or tax for payment to unauthorized insurers
General overview of tax matters
Owner's perspective

- Initial and subsequent capital contributions are not deductible
- Shareholder dividends received from domestic captives, foreign captives established in certain treaty countries and foreign captives that have made and hold valid IRC §953(d) elections are generally treated as qualified dividends for individual shareholders
- Shareholder dividends received from captives formed in non-treaty countries and “Subpart F” inclusions are not treated as “qualified dividends” for individual shareholders
- Shareholder dividends received by corporate shareholders may be eligible for a “dividends received deduction”
- Policyholder dividends are generally treated as items of ordinary income for federal tax purposes
Insurance companies other than life insurance companies, that is property and casualty (P&C) insurance companies, are taxed under IRC §831. Prior to 2004, IRC §831 did not specifically define what constitutes an insurance company. However, the Pension Funding Equity Act of 2004 amended IRC §831 to define “insurance company” – the term “insurance company” means a company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Accordingly, a company whose other activities (e.g., relating to investments, financing arrangements) outweigh its insurance activities is not considered to be an insurance company for this purpose.
This new definition brings P&C companies in line with life insurance companies, which had to meet the same definition under IRC §816.

Implicit in the definition of “insurance company” is the issue of what constitutes an “insurance’ or ‘reinsurance contract.” Unfortunately, while “insurance company” is now a defined term there is no statutory authority defining the term “insurance contract” for federal income tax purposes*. 

* IRC §7702(a) defines a life insurance contract, but not an insurance contract
Additionally, numerous courts have required that insurance companies meet the “commonly accepted notion of insurance” standard, which includes:

- The company must be regulated as an insurance company
- The company must issue contracts / policies of insurance
- The company must be formed for non-tax business reasons
- Premiums are charged at an arms-length rate (for related parties) / are actuarially determined
- The operational and investment activities of the company should be typical of commercial insurance enterprises
Helvering v. Le Gierse (1941)

- Eighty-year-old taxpayer purchased an annuity contract and a life insurance contract shortly before her death.
  - No health examination was required, but the insurance company would not have issued the life insurance contract without the annuity.

- Considerations:
  - Totality of the arrangements.
  - Insurance risk and investment risk.
  - Risk shifting.
  - Risk distribution.

- Operating together, the two contracts did not shift any risk from the taxpayer to the insurance company.
Insurance Risk

- The courts established the first insurance company test in Amerco v. Commissioner, requiring that an arrangement involves an insurance risk.
- The court stated that the key to insurance is that the insured faces a hazard and the insurer agrees to pay if or when the loss event occurs.
- The Internal Revenue Service (the “Service” or the “IRS”) has indicated that an important aspect of an insurance risk is “fortuity.”
- The courts and the IRS do not accept the following as an insurance risk:
  - Investment risk: the mere change in price of a commodity is not an insurable risk.
  - Timing risk: the IRS ruled that an insurance policy covering a loss that was already known but the timing of the payment was uncertain was not insurance.
  - An insurance risk is often analyzed under FAS 113 which requires a reasonable possibility of a significant loss to the insured under the contract (i.e., a 10% chance of a 10% loss).
• The seminal case for defining an insurance contract was Helvering v. Le Gierse, 312 U.S. 531 (1941), where the courts established that a contract of insurance must involve **Risk Shifting** and **Risk Distribution**

• Although the Le Gierse court did not define these terms specifically, subsequent courts have provided guidance as to their meaning
Risk Shifting

- Risk shifting is viewed from the presence of the insured
- In order for risk shifting to exist, the insured must transfer its risk of economic loss due to some hazard to an insurance company
- The “balance sheet test” is also frequently applied to determine whether an insured has shifted its risks to the insurer (under this test, a sole shareholder generally cannot shift its risks to its wholly-owned captive subsidiary)
- Whether the captive is adequately capitalized and/or supported by financial guarantees can impact this element
Risk Distribution

- Risk distribution is viewed from the insurance company’s perspective.
- Based on the actuarial principle of “the law of large numbers,” risk distribution entails spreading risks among a large group allowing the insurer to reduce the possibility that one claim will exceed the premiums collected.
- While the courts have addressed the concept of risk distribution, no one case defines what constitutes adequate risk distribution in a captive arrangement (e.g., number of underlying insureds, number of entities).
Definition of Insurance

- Parent deemed to have not shifted its risk to Captive.
  - Balance sheet approach
- Premiums paid from Parent to Captive are not deductible.
- Captive is not considered an insurance company.
**Parent**
- Parent has not shifted its risk to Captive.
  - Balance Sheet approach.
- Premiums paid from Parent to Captive are not deductible.

**Subs**
- Subs generally shift risk to Captive.
- Premiums paid from Subs to Captive are generally deductible provided certain bona fides are satisfied: premiums are arm’s length, the Captive is adequately capitalized, and the Captive is not propped up.

**Captive**
- Generally treated as an insurance company.
Definition of Insurance

Parent
- Parent generally shifts its risk to Captive, provided sufficient third-party risk is present.
  - Third-party risk benchmark \( \geq 30\% \) of total premium.
- Premiums paid from Parent to Captive are generally deductible, provided bona fides are satisfied.

Subs
- Subs generally shift risk to Captive.
- Premiums paid from Subs to Captive are generally deductible provided certain bona fides are satisfied.

Captive
- Generally treated as an insurance company.
**Definition of Insurance**

**Insured**
- Generally shift risk to Captive.
- Premiums paid from insureds to Captive generally deductible, provided bona fides are satisfied.

**Captive**
- Generally treated as an insurance company.
Revenue Ruling 2005-40

Service presents four (4) scenarios pertaining to a domestic corporation with a large fleet of vehicles:

1. Facts
   - X places its risk to Y, an unrelated entity.
   - Y assumes no other risk.
   - Y meets general insurance bona fides; arm’s length premiums, adequate capital, etc.
   - Holding: No insurance as risk distribution is not present.

2. Facts
   - Same as Scenario 1 except, Y enters into an arrangement with Z, an unrelated party to X and Y, to accept Z’s risk.
   - Z’s premium constitutes 10 percent of Y’s total premium.
   - Holding: No change in holding with respect to X premiums, as 10 percent of the premium is an insufficient pool of risk to distribute X’s risk.

3. Facts
   - X has 12 single member LLCs which are disregarded for tax purposes.
   - Y contracts with 12 LLCs.
   - Y meets general insurance bona fides.
   - Holding: No insurance. Similar to Situation 1.

4. Facts
   - X has 12 separate subsidiaries.
   - Y contracts with X’s separate subsidiaries.
   - Holding: Arrangement is insurance as both risk shifting and risk distribution are present.
Unsettled Waters Regarding Revenue Ruling 2005-40

- Taxpayers have been litigating the Service’s view articulated in Rev. Rul. 2005-40.
- Several cases have been moving through the judicial process (e.g., Rent-A-Center - to be discussed later)
- Tension at the Service regarding proper policy considerations.
- The Service’s 2011-2012 Priority Guidance Plan included the issuance of a revenue ruling under section 801 addressing the application of Revenue Ruling 2005-40 or Revenue Ruling 92-93 to health insurance arrangements that are sponsored by a single employer. See Rev. Rul. 2014-15 (to be discussed later)
Q: What does it mean if you have an insurance arrangement and you are a tax-exempt insured?

A: It is generally more tax efficient if arrangement is not insurance.
Definition of Insurance
PLR 200518010

Facts
- Parent is a tax-exempt organization.
- Parent is the sole owner of several entities; some are tax-exempt and some are taxable.
- Certain tax-exempt affiliates have a controlling interest in condo associations relating to medical office buildings.
- Small group of non-controlled affiliates (not pictured).
- Parent formed insurance subsidiary (Captive) in a foreign country.
- Premium
  - Parent – 0.3%
  - Parent Affiliates – 96.3%
  - Condo & Other – 3.4%
- Parent guaranteed fronting companies on all obligations.

Conclusions
- Not insurance.
  - Guarantee negates risk shifting.
  - Small amount of unrelated risk (3.4%) does not create risk distribution.
  - Captive not an insurance company.
- As the arrangement is not an insurance arrangement, the excise tax is not applicable.
Definition of Insurance
Non-insurance scenario – Disregarded entity

Facts
• Tax-exempt entity forms a captive insurance company in a foreign jurisdiction.
• The tax-exempt entity pays premiums to the captive.

Conclusions
• Given the parent-subsidiary relationship, this is not an insurance arrangement.
• Captive is not an insurance company.
• Captive is a foreign eligible entity and can elect to be disregarded or treated as a corporation.
• A disregarded entity is treated as a division of the parent. Treas. Reg. § 301.7701-2(a); Rev. Rul. 2005-40; PLR 200518010.
• No CFC or excise tax issues.
Foreign domiciled captives with U.S. tax residence should also consider the implications of the following:

- Controlled Foreign Corporations (including RPII)
- IRC 953(d)
- Federal excise tax
- Withholding tax
- Transfer Pricing
- FATCA
- UBIT (for tax exempts)
- Indirect tax issues

*See Appendix A for additional information*
Recent Developments

PLR 200628018 – Embedded Warranties

• Controlled Foreign Corporations (including RPII)
• Released 7/14/06 and involved a consumer product manufacturer’s short-term warranty obligation
• Holding – express limited warranty “embedded” in product’s sales price and terms is not an insurable risk for federal tax purposes:
  – Defects likely existed at the time of sale and were created during the manufacturing process when the manufacturer had control (thus a business risk lacking “fortuity,” a key element of insurance)
  – Warranty automatic with product purchase – no buyer opportunity to opt out and pay a lower price so cannot treat as a separate item for tax purposes
• Distinguishable from an extended service contract which is separately purchased by the consumer and does qualify as insurance for federal tax purposes
Recent Developments

PLR 200629029 – Insurable Risk

- Released 7/21/06 and involved future decommissioning costs of a nuclear power plant
- Holding – a business risk is not an insurable risk for federal tax purposes:
  - Since federal law requires a provision for decommissioning expense to be maintained throughout the operating life of a plant, no fortuity or hazard exists (no event risk because incurring decommissioning costs is inevitable)
  - Only variables are timing of payout and ultimate amount of expense
- No tax benefits available to unrelated captive writing this type of risk
- Distinguishable from life insurance in which event is also inevitable, but timing is uncertain
Recent Developments

Rev. Rul. 2007-47—Insurable Risk

- Domestic taxpayer engaged in an undisclosed hazardous business that was required by statute to engage in environmental restoration once its facilities were shuttered
- The need for remediation was certain, but the scope, cost, and timing were unknown (present value of estimated cost was $150x)
- Taxpayer purchased a policy from an unrelated insurer for $150x with a limit of $300x
- Because the loss was certain to occur, the IRS held that there could be no insurance without “fortuity” and thus no insurance risk existed
- Taxpayer denied a premium deduction and insurer denied loss reserve deduction
- The IRS stated that Rev. Rul. 2007-47 did not necessarily apply to reinsurance arrangements (including retroactive reinsurance, such as loss portfolio transfers), or to arrangements involving unanticipated environmental expenses, cost overruns, or product warranties
PLR 200724036 – Insurance Company Status

• IRS denied insurance company status
• Facts are redacted and unclear, but some IRS concerns were:
  – Small number of insured entities
  – Large percentage of total premiums originated from largest insured
  – Lack of homogeneity among risk exposures
  – Too few exposure units
  – Too many different lines of high risk coverage
  – A single maximum loss would (apparently) exceed capital
Recent Developments

FSA 20072502F – Risk Shifting

• Involved a reinsurance treaty, but could impact loss portfolio transfers
• IRS attorney concluded that risk shifting is not determined by RFAS 113 or SSAP 62.
• The FSA requires that “tax savings” be part of the analysis
• “If the net present value of the anticipated losses do not materially exceed the premiums plus the tax savings, the transaction does not transfer risk…”
Recent Developments

TAM 200816029 – Insured Partnerships

- IRS examined a related party captive arrangement that involved the insurance of affiliated corporations, limited liability companies, and limited partnerships
- For purposes of determining whether a tax partnership should be treated as a separate insured from a risk shifting and risk distribution perspective, the IRS found the following:
  - For limited partnership entities, where a general partner is liable in excess of the partnership assets, the general partner (not the LP) is viewed as the insured
  - For limited liability companies, where liability does not extend beyond the entity, the LLC is considered to be the insured (similar to a corporation)
- Despite recognizing the LLC as the insured party when the LLC is treated as a tax partnership, the IRS emphasized its Rev. Rul. 2005-40 position that “disregarded” LLCs are not counted as separate insureds for risk shifting and risk distribution purposes
PLR 201015043 – Primary and Predominant Test

- IRS examined a 501(c)(15) captive owned by the family trust of a bank owner
- Captive reinsured a number of coverages provided to the bank’s customers, including credit life, credit disability, credit property, and involuntary unemployment insurance
- Captive also engaged in loaning funds to friends, family, and associated businesses
- IRS found that the insurance contracts qualified as insurance from a federal tax perspective since they satisfied the requisite risk transfer and risk distribution elements of insurance
- However, IRS denied captive’s federal tax status as an insurance company because its primary and predominant business activity was not insurance, but rather making loans
- IRS cited overcapitalization, little insurance marketing activity, lack of staffing, and investment in non-liquid assets as reasons for its position
Recent Developments

Proposed Treasury Regulation Section 301.7701-1

• On September 14, 2010, the IRS issued proposed rules regarding the classification of protected cell companies (“PCCs”) for federal tax purposes
• Historically, there has been no clear guidance on the taxation of PCCs
• The primary issue addressed by the Proposed Treasury Regulations relate to whether each individual cell or the cell company as whole should be treated as the taxable entity
• The proposed rules provide that the foreign individual cell should be treated as a separate taxpayer only if the transactions within the cell qualify as insurance; domestic cells are always classified as separate entities
• Pursuant to Notice 2008-19, IRS also requested comments from practitioners regarding these matters, with most replies in favor of treating the individual cells as separate taxable entities
Rev. Rul. 2014-15

Facts

• Domestic public company X provides health benefits to retirees and their dependents through a voluntary employees’ beneficiary association (“VEBA”)

• VEBA enters into Contract A with unrelated (life) insurance company Y
  – Y to reimburse VEBA on a quarterly basis for medical claims incurred by the covered retirees and their dependents paid by the VEBA

• Y enters into Contract B with X’s wholly owned subsidiary, S1
  – Y reinsures 100% of its liabilities under Contract A
  – Contract B is S1’s only business
Rev. Rul. 2014-15

Holding

- IRS held, that Contract B constitutes insurance for federal income tax purposes and that S1 qualifies as an insurance company

- Risk Shifting
  - Economic benefit to the retirees since it relieves them of the expense of purchasing health insurance for themselves and their dependents
  - Neither X nor VEBA have any commitment or obligation to offer health benefits (at the time Contract A went into effect)
  - Both X and VEBA may cancels any provided coverage at any time

- Risk Distribution
  - Risks under Contract B are distributed among large group of covered individuals

Caution: Holding based upon the specific facts and ruling did not address certain issues that would come up if benefits were provided other than through a VEBA
Rent-A-Center Inc. v. Commissioner

Facts & Background

- Rent-A-Center Inc. (“RAC”) is a U.S. based company and the parent of 15 affiliated subsidiaries. RAC subsidiaries own and operate more than 2,500 rent to own stores throughout the U.S.
- In 2002, RAC formed a captive insurance company, Legacy Insurance Co Ltd (“Legacy”) in Bermuda to mitigate its risk related to directors and officers insurance, workers’ compensation, and other general liability insurance policies.
- Legacy charged RAC a premium based on actuarially determined expected total losses of the insured group (i.e. – arm’s length). RAC paid the premium and allocated the expense among the operating subsidiaries using the same formula used to allocate the expense when premiums were being paid to a third party insurer. None of the premium was allocated to RAC.
- Legacy was registered as a Class 1 insurance company (only insures risk of owners and affiliates) in Bermuda and was required to meet certain minimum capitalization thresholds. Legacy’s capitalization well exceeded this threshold and was based on a study performed by third party risk consultants.
- Legacy received permission from the Bermuda Monetary Authority (“BMA”) to treat Deferred Tax Assets (“DTA”) and the treasury stock purchased from RAC as general business assets when calculating its minimum solvency margin and liquidity ratio, respectively.
- RAC guaranteed payment of all amounts reflected as DTAs on Legacy’s balance sheet; RAC never made any payments with respect to the parental guaranty.
Rent-A-Center Inc. v. Commissioner (Cont’d)

Opinion

• The Tax Court (majority opinion) rejected the Service’s assertion that the transactions among RAC, its affiliates and Legacy was a circular flow of funds and thus a sham.
• The majority opinion concluded that RAC presented convincing evidence that risk was present, risk was shifted and distributed, and that Legacy was a bona fide insurance company.
• The dissenting opinion argued that the parental guarantee indicated that risk was not shifted.

Implications

– Majority opinion contains a number of favorable implications for taxpayers who have captives or are considering forming captives, including:
  • A limited parental guaranty may be acceptable in certain cases
  • Purchase of treasury shares does not result in a circular flow of cash (helpful for captive owners that want to purchase related party financial instruments)
  • Risk distribution can be determined by the number of statistically independent risks
  • Premiums and claims can be netted in certain circumstances
Recent Developments

Securitas Holdings Inc. v. Commissioner

Facts & Background

- Securitas Holdings Inc. (SHI), a U.S. company with a Swedish parent, owned several U.S. and foreign operating subsidiaries providing security services. Each subsidiary had various kinds of risk, including workers’ compensation, general liability, and automobile liability. During the years in issue, these subsidiaries had over 90,000 employees and operated over 2,000 vehicles in connection with business activities. In an effort to manage the costs of each of SHI’s domestic subsidiary’s insurance retentions, SHI caused a long-dormant Vermont captive, Protectors, to issue insurance coverage for most of the domestic subsidiaries’ retentions. Coverage for the foreign subsidiaries’ retention risks was purchased from an unrelated insurer. All of this risk was reinsured with an Irish reinsurer, SGRL, owned by SHI’s foreign parent; SGRL reinsured risks of more than 25 separate entities.
Securitas Holdings Inc. v. Commissioner (Cont’d)

Facts & Background

• SHI also owned an insurance company, Centaur, which received no premium income and reported as tax-exempt under Internal Revenue Code section 501(c)(15). Because eligibility for this tax-exemption is determined on a controlled group basis, the receipt by Protectors of amounts qualifying as insurance premiums from its sister corporations would disqualify Centaur as tax-exempt. To prevent this from occurring, SHI guaranteed Protectors’ performance of its insurance obligations, which under existing IRS guidance would mean that the amounts received by Protectors would not qualify as insurance premiums. No amounts were ever paid under this guaranty.

• Upon examination, the Service determined approximately $30.3 million in deficiencies in tax for SHI, based on the Service’s partial disallowance of interest expense deductions and deductions for insurance expenses involving a captive insurance arrangement. The only question at issue before the Tax Court was whether the amounts paid to Protectors were deductible as insurance premiums.
Recent Developments

Securitas Holdings Inc. v. Commissioner (Cont’d)

Opinion

• The Tax Court held that related corporations were entitled to deduct, as insurance premiums, amounts that were paid on their behalf by their parent corporation to a sister Vermont captive, which reinsured the risk with a related Irish reinsurer.

• The Tax Court Found:
  • Risk shifting existed despite the parent’s guarantee of performance of the Vermont captive
  • Risk distribution existed despite the fact that in one year the captive insured only four sister corporations, one of which represented close to 90% of the risk, and
  • Insurance in its commonly accepted sense existed despite the captive’s relatively low gross premium to surplus ratio and the group’s use of offsetting journal entries to credit premiums and claim payments

Implications

– Opinion continued a number of favorable implications for taxpayers who have captives or are considering forming captives, including:
  • The existence of a parental guarantee does not automatically result in the loss of risk shifting where the captive is adequately capitalized
  • Risk distribution was met in spite of the fact that most of the risks insured belonged to one company, a result at odds with the Service’s position enunciated in Rev. Rul. 2005-40, and a result emphasizing that risk distribution can be determined by the number of statistically independent risks
Recent Developments

IRS

- Continue to ignore RAC and Securitas in public guidance
- Priority Guidance plans continue to include captive insurance as an agenda item
- Referenced Section 831(b) “micro” captives on its “Dirty Dozen” list of tax abusive transactions/tax shelters
  - Scrutinizing promoters involved in large-scale implementation of such arrangements
  - Looking for captives charging artificially high premiums for “non-traditional” risks
  - Captives will minimal losses could be vulnerable to challenges
- Larger group of reviewers has been established to assess Section 953(d) elections
Recent Developments

State Tax

- States continue to pass legislation affecting captives
- Recent States: Illinois, Indiana, Ohio, Texas
  - States enacting captive regimes:
    » Indiana – HB 1206
    » Ohio – HB 117
    » Texas - SB 734
  - States enacting or expanding application of self-procurement or unauthorized insurance tax:
    » Illinois – SB 3324
    » Texas – Rule 34 TAC Section 3.835
What is a segregated portfolio company / cell company ("SPC")?

- Captive is often owned by a sponsor that allows third party insureds to “rent” a “cell” from the captive to place their risks in isolation from the risks of other cells and the sponsor’s “core”

- Cell structures may be attractive to smaller companies interested in easing into a captive insurance vehicle

- Taxpayers have frequently treated cells within a cell company as one entity from a federal tax perspective for purposes of bolstering their position that the transactions involving the insureds within the cell qualify as insurance

- IRS initially issued guidance that the federal tax analysis regarding whether an arrangement qualified as insurance should be made on a cell by cell basis rather than at the level of the cell company as a whole; this guidance did not indicate whether each cell should be treated as a separate entity

- Proposed Regulations later addressed whether a cell should be treated as a separate entity
Impact of the Common Reporting Standard (CRS)

• Worldwide, the financial services industry is by now very familiar with FATCA – the U.S. Foreign Account Tax Compliance Act

• CRS is a similar to FATCA but far more extensive

• 97 Participating Jurisdictions have committed to the automatic exchange of information (AEOI) under the CRS - most entitled receive information on their taxpayers foreign Financial Accounts

• Before January 1, 2016, all entities in “early adopter” Participating Jurisdictions – e.g. Cayman, BVI, Bermuda - must consider their “entity classification” for the purposes of the CRS

• Entity classification rules are different under the CRS than under FATCA
  – Many entities that are not Reporting Financial Institutions (RFIs) under FATCA will be RFIs under the CRS
Automatic Exchange of Information (AEOI) on Financial Accounts by Tax Authorities

Three Regimes

- U.S. Foreign Account Tax Compliance Act (FATCA) 7/1/2014
- UK FATCA (subsumed by CRS in 2017) 7/1/2014
- OECD’s Common Reporting Standard (CRS) 1/1/2016

Purpose

a) To better fight tax evasion
b) To ensure tax compliance

Practical Effect

- Reporting Financial Institutions are now “the primary data collectors for tax authorities”
The U.S. is not a CRS Participating Jurisdiction but has committed to AEOI under reciprocal Model 1 Intergovernmental Agreements (IGAs).
Offshore Captives and Reinsurance Companies are Reporting Financial Institutions (RFIs) under the CRS if they are classified as Specified Insurance Companies or Investment Entities.
CRS uses the same definition as FATCA…

1. Insurance Company; and

2. issues, or is obligated to make payments with respect to either:
   a) Annuity Contract
      - Payment periods determined in whole/part by reference to the life expectancy of individual(s)
   b) Cash Value Insurance Contract
      “Cash Value”:
      - Includes amount due to policyholder on surrender/termination (or amount policyholder can borrow against policy, if greater)
      - Excludes amounts payable as death benefit or to indemnify economic loss
CRS has two tests for a professionally managed Investment Entity:

(1) Income Test
at least 50% of its gross income is passive income; and

(2) “Managed By” Test
It is managed by (in whole or in part) another Entity that is:
(a) a Depository Institution, a Custodial Institution, a Specified Insurance Company, or an Investment Entity [being a professional manager], and
(b) performs, either directly or through another service provider any of these activities or operations on behalf of the managed entity:
   i. trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.);
      foreign exchange; exchange, interest rate and index instruments;
      transferable securities; or commodity futures trading;
   ii. individual and collective portfolio management; or
   iii. otherwise investing, administering, or managing Financial Assets or money.
Investment Entity or Non-Financial Entity?

**Income Test:**
Is at least 50% of its gross income passive income?

- Yes → "Managed by" Test: Does it satisfy the "managed by" test? →
  - Yes: Investment Entity = Reporting Financial Institution
  - No: Passive Non-Financial Entity

- No → Asset Test: Do at least 50% of its assets produce, or are they held to produce, passive income?
  - Yes: Passive Non-Financial Entity
  - No: Active Non-Financial Entity
New Regulatory Obligations of Reporting Financial Institutions (RFIs)

Each RFI must

1. Establish policies and maintain procedures designed to identify Reportable Accounts:
   (a) identify each jurisdiction in which an Account Holder or a Controlling Person is resident for income tax or corporation tax purposes or for the purpose of any tax imposed by the law of the jurisdiction that is of a similar character to either of those taxes;
   (b) apply the due diligence procedures set out in the CRS; and
   (c) ensure that any such information or a record of the compliance steps taken in respect of a Financial Account is kept for six years

2. Appoint a Principal Point of Contact for all purposes of compliance with the CRS and register the RFI with the domestic Tax Authority

3. Report annually to the domestic Tax Authority in respect of Reportable Accounts *(preferably using XML format files but manual electronic reporting is possible)*

4. Comply with the domestic Tax Authority’s exercise of its regulatory powers

5. Consider the impact of Anti-Money Laundering Regulations where there is knowledge or suspicion an account holder/controlling person is using the account for tax crimes
CRS Entity Classification
Each Reporting Financial Institution (RFI) must establish documented policies and procedures to comply with the CRS and Commentary on the CRS

CRS in force in "early adopter" Participating Jurisdictions 1/1/2016

CRS Remediation
Completed for Pre-Existing Accounts 12/31/16

CRS Notification to Cayman DITC 4/30/17

CRS Reporting to Cayman DITC 5/31/17

CRS in force in all Participating Jurisdictions 1/1/2017
Appendix A
U.S. Tax of Foreign Domiciles
While many off-shore captive domiciles have low or zero income tax rates, U.S. corporations and individuals who are tax residents (e.g., U.S. citizens) are generally taxed on their worldwide income unless certain exceptions apply.

This means that, under most scenarios, U.S.-owned foreign captive insurance companies or their owners will be subject to federal income tax on the captive’s earnings.
Under the Code, U.S. owners of controlled foreign corporations ("CFCs") are taxed on their share of the CFC's Subpart F income.

A CFC is generally defined as a foreign corporation in which more than 50% of its vote or value is owned by "U.S. shareholders".

A U.S. shareholder is generally defined as a U.S. individual or entity that owns 10% or more of the vote of the foreign corporation.

Section 952 of the Code includes insurance income as a type of Subpart F income.
• U.S. owners of CFCs are not taxed on “exempt insurance income,” which is defined as:
  – Income derived from an exempt insurance contract, which is a contract insuring non-U.S. risks
  – The contract is issued from a “qualifying insurance company,” which is a company that is licensed to sell insurance in its home country, has more than 50% of premiums from unrelated parties, and would qualify as an insurance company under U.S. federal tax law
  – Further, no contract issued from a qualifying insurance company will be treated as exempt unless more than 30% of its premiums are from the insurance of home country risks
  – Consequently, U.S.-focused captive programs generally do not generate exempt insurance income
“Related party insurance income” ("RPII") is generally derived from any insurance contract where the insured party is a U.S. shareholder of the CFC or a party related to that shareholder.

In the case of a captive with RPII:

- the captive generally will be considered to be a CFC if 25% or more of the vote or value of the foreign corporation is owned by U.S. shareholders (the standard 50% ownership threshold for CFCs is replaced in the RPII context with a lower threshold).
- a U.S. shareholder is defined as including U.S. individuals or entities with any ownership in the captive (the standard 10% vote threshold for U.S. shareholder status is replaced in RPII situations with a lower threshold).
Section 953(d) of the Code allows for a captive qualifying as a CFC to elect to be taxed as if it were a U.S. domiciled corporation. This election results in the following:

- No Subpart F income inclusions
- No filing of IRS forms applicable to foreign transactions (e.g., IRS Form 5471)
- Avoidance of any branch profits tax
- Avoidance of Federal Excise Tax
- Losses at the captive are treated as dual consolidated losses
Section 4371 of the Code imposes an excise tax on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer.

Rates:
- Direct business:
  - Casualty and indemnity bonds: 4 percent
  - Life, sickness, accident & health, and annuity contracts: 1 percent
- Reinsurance: 1 percent

Revenue Ruling 2008-15 describes the insurance excise tax consequences of insurance premiums paid by one foreign (re)insurer to another.

Service position is the FET applies to every transaction of reinsurance with a foreign reinsurer (if US risks are reinsured) – Cascading Theory.

IRS exam activity involving the FET.

Reinsurance of captives with foreign reinsurers.

The U.S. has a number of bilateral treaties in place that eliminate FET (e.g., UK, Ireland; however, the Cayman Islands are not eligible for a treaty.)
30% withholding tax (WHT) on certain types of income that is
  - U.S. sourced income,
  - paid to a foreign corporation, and
  - not effectively connected with a U.S. trade or business

Treaty exceptions may apply

Examples:

• Interest (with certain exceptions)
• Dividends
• Rents
• Salaries and wages
• Premiums
• Any other “fixed or determinable annual or periodical” income
No WHT on interest if

- The debt instrument is in registered form, and
- The beneficial owner of the obligation is not a U.S. person

Before the Hiring Incentives to Restore Employment Act (2010), interest paid on non-registered obligations was also exempt from WHT under § 881(c).

- The current provision is effective for obligations issued after March 19, 2012
- No exception when interest is received by a CFC from a related person
U.S. Investments by Foreign Corporations

Dividends

• No exception for dividends
• Subpart F inclusion of gross dividend amount
• No credit or deduction for tax withheld imposed by § 881
  – Treas. Reg. § 1.952-1(b)(2)
Foreign captive insurance companies may be subject to FATCA as foreign financial institutions (FFIs) or non-financial foreign entities (NFFEs)

- Captives offering cash value insurance contracts or annuity contracts are FFIs
- Non-life captives and reinsurance captives as NFFEs
- Section 953(d) electing companies that issue cash value life insurance contracts and annuity contracts are considered “foreign” for FATCA purposes
- Other section 953(d) companies are considered US companies

Premiums paid on US sourced risks considered US source

U.S. sourced insurance premiums are subject to 30% withholding unless the foreign captive insurance company provides proper documentation (eg Form W-8BEN-E)

- NFFE insurance companies that are not publicly traded are generally considered passive NFFEs
- Passive NFFEs are required to identify certain of their US shareholders
Foreign Account Tax Compliance Act (FATCA)

- Brokers handling payments are considered intermediaries
  - US brokers may be treated as the payee of payments provided they are FATCA complaint. FATCA documentation and reporting therefore is shifted to them
  - Non-US brokers are intermediaries with respect to payments and must transmit FATCA documentation from insurance companies to the US payor
- Premium payments may need to be reported
  - Premiums subject to withholding (or which should have been withheld upon) are reported on Form 1042-S
  - Premiums to insurance companies that are passive NFFEs with substantial US shareholders get reported on Form 8966
- Contracts incepted before 1 July 2014 and which have not been materially altered are eligible to be grandfathered
- Offshore payments of insurance premiums may be eligible for an exception from FATCA until 1 January 2017 (but brokers and the industry is getting ready now anyway)
Unrelated Business Taxable Income

- Tax-exempt entities may be subject to tax on “unrelated business taxable income” (UBTI)
- Dividends are generally not UBTI
- Generally, subpart F income is characterized as a dividend and is not UBTI
- Subpart F “insurance income” is UBTI under § 512(b)(17) if exceptions do not apply
- Look-through principles apply in determining how to characterize the income from the CFC
U.S. domiciled captives are typically subject to state tax on their gross receipts / premiums received that are sourced to that state.

To the extent that a captive is outside a state’s jurisdiction to tax, a “premium tax” (often referred to as a direct procurement tax) is often applied at the insured level (similar to a sales tax) in lieu of taxing the captive’s income at the captive level.

Under this approach, state tax benefits could be achieved in the arrangement as the captive’s investment income would not be subject to state tax.

However, tax authorities have increasingly focused on so-called “stuffed captive” structures in which the captive has received excessive capital in order to take advantage of this state tax benefit.
U.S. Taxation of Foreign Domiciled Captives
State Tax Issues

• Foreign domiciled captives are not subject to U.S. state premium tax.
• However, many states impose a direct procurement / self-procurement tax or tax on unauthorized insurers (there have been constitutional law challenges to such taxes).
• As states look for more revenue, auditors are assessing self-procurement taxes on captive arrangements at an increasing rate.
• Self-procurement tax is generally levied based upon where the contract of insurance is entered into, as opposed to where the risk is based (e.g., Todd Shipyards).
• Careful planning and execution of the insurance procurement process can bolster filing positions followed in connection with self-procurement taxes.
State Tax on the Purchase of Insurance

Three Ways to Purchase – Three Ways to Tax

• Purchase a policy from an insurer authorized to write in the state
  – Authorized insurer pays a premium tax to the state

• Purchase a policy using an authorized broker, from an insurer not authorized in the state
  – Broker collects tax from the insured and pays it to the state

• Purchase a policy from a company not licensed in the state
  – Insured pays the tax to the state
1. Purchase a policy from an insurer authorized to write in the state.

- Authorized insurer – an insurance company licensed with that state's insurance department (e.g., GEICO, State Farm, Nationwide, Progressive)
  - Authorized can include an insurance company licensed as a captive in that state
- States impose a premium tax on authorized insurers.
  - Premiums Written x 2% (average tax rate)
  - Premium tax cost is built into pricing for the policy
- Insured pays no direct tax to the state
2. Purchase a policy using an authorized broker.
   • Specialized risk – not offered by insurers licensed in the state (e.g., workers’ compensation, professional liability)
     – Excess insurance – covers liability above a stated amount
     – Surplus Lines – not subject to state rates and forms
   • Insured deals with a broker authorized with the state to place the specialized insurance with an unauthorized/non-licensed insurer
   • The broker collects the tax from the insured and pays it over to the state
3. Purchase an insurance policy directly from an insurance company not licensed in the state.

- Specialized risk – not offered by insurers licensed in the state (e.g., workers’ compensation, professional liability)
- Insured contacts the unauthorized insurance company (could be a captive not licensed in the state or in the United States) directly to place the insurance
- The state requires the insured to pay a flat premium tax on the premiums paid to the unauthorized insurance company
  - Rates range from 1% to 6% of premium
  - 38 states imposed this type of tax
The Nonadmitted Reinsurance Reform Act (NRRA)

- The only tax provision included in Dodd-Frank
- Purpose was to make uniform and simplify the payment of taxes on excess and surplus lines insurance
  - Make placement of such insurance easier
  - Special risk insurance
  - Previous law could subject > 100% of premiums to state tax
- Only the “home state” of the insured can impose the tax
  - Home state – headquarters or principal place of business
  - Tax imposed on 100% of the premiums
    - Taxes premium on risk not located in the home state
  - States to share tax revenue with other states where risk is located
Appendix B
U.S. Compliance (Common Forms)
Common U.S. Federal Tax Forms

- IRS Form 5471: information return required to report activities of foreign corporations, including foreign captives that have not made a Code Section 953(d) election to be treated as a domestic corporation.

- IRS Form 926: information return required to report non-taxable property transfers (e.g., capital contributions) to foreign captives that have not made a Code Section 953(d) election to be treated as a domestic corporation.

- IRS Form 720: tax return required to report federal excise taxes applicable to premiums paid to non-treaty foreign insurers (such as Cayman captives without a Code Section 953(d) election); often filed by the onshore insureds or the insurance broker.
Common U.S. Federal Tax Forms (Domestic Captives and Offshore Captives with a Section 953(d) “Domestication” Election)

- IRS Form 1120PC: income tax return to report activities (e.g. premium and investment income)
- IRS Form 990: tax return to report activities of a tax-exempt “small” insurance company
- IRS Form W-9: provided to “withholding agents” involved in payments of “U.S. source” income (e.g., interest on corporate bonds, T-bills, dividends from mutual funds / regulated investment companies)

Other U.S. Federal Tax Forms (All Offshore Captives - With and Without a 953(d) Election)

- IRS Form 1120F: “protective” income tax return
  - Typically is a “zero” return but can also be used to obtain refunds for any over-withheld taxes on U.S. source income earned by the captive
Common U.S. Federal Tax Forms (Offshore Captives without a 953(d) Election)

- IRS Form W-8BEN: provided to the withholding agents involved in payments of U.S. source income
- IRS Form W-8BEN-E: to be provided to withholding agents paying premiums on US sourced risks.
  - Most property and casualty captives will normally be classified as NFFEs. Unless publicly traded, they should be considered passive NFFEs
    » Substantial US shareholders will be indicated on Form W-8BEN-E
- IRS Forms 1042-S and 1042: used by withholding agents to report payments to non US persons
  - For insurance premiums, reporting only required when there is actual withholding or should have been withholding
- IRS Form 8966: used among other things by withholding agents to report substantial US owners in passive NFFEs
Appendix C
Impact of the OECD Common Reporting Standard (CRS) on Captives
FATCA statistics from the IRS
1 November 2015

- Over 170,000 Foreign Financial Institutions registered with the IRS
- Cayman leads due to its dominant fund industry
- Very small number of Captives and Reinsurance Companies registered as Reporting Financial Institutions
- Sets the scene for Reporting Financial Institutions under OECD’s Common Reporting Standard (CRS)
Automatic Exchange of Information (AEOI)
Annual Flow of Financial Account Information

Country A
Reportable Jurisdiction

Taxpayer who is the Account Holder
(or if that is a Passive Non-Financial Entity, its Controlling Person)

Verification of Reportable Person’s Financial Account Information

Country B
Participating Jurisdiction

Reporting Financial Institution (RFI):
- Depository Institution
- Custodial Institution
- Specified Insurance Company
- Investment Entity

Financial Account with Reporting Financial Institution

Annual reporting of Information on Reportable Account

Automatic Exchange of Information on Reportable Accounts

Tax Authority of Taxpayer

Tax Authority of RFI
“Passive Income”
Relevant to Investment Entities / Non-Financial Entities

Reference must be made to each jurisdiction’s particular rules.

Generally includes the portion of gross income that consists of:

a) dividends;
b) interest;
c) income equivalent to interest;
d) rents and royalties, other than rents and royalties derived in the active conduct of a business conducted, at least in part, by employees of the NFE;
e) annuities;
f) the excess of gains over losses from the sale or exchange of Financial Assets that gives rise to the passive income described previously;
g) the excess of gains over losses from transactions (including futures, forwards, options, and similar transactions) in any Financial Assets;
*except in the case of an NFE that regularly acts as a dealer in Financial Assets*
h) the excess of foreign currency gains over foreign currency losses;
i) net income from swaps; or
j) amounts received under Cash Value Insurance Contracts.
Unlike FATCA, there is no withholding tax regime

CRS compliance and enforcement will be entirely domestic

In the Cayman Islands, we expect:

- Compliance
  - Regulatory audit and investigation powers

- Enforcement
  - Administrative Fines
  - Criminal Sanctions

- Monitoring and Review of the Government's implementation of the CRS by the OECD Global Forum

The OECD has identified over forty significant differences between FATCA and the CRS.

Most of them affect all RFIs.

Establishing policies and procedures for the CRS involves:

- Study of the Common Reporting Standard, CRS Commentary, CRS-enabling regulations, regulatory guidance, and monitoring the websites of RFI’s domestic tax authority and the OECD.
- Updating RFI’s legal documents.
- Implementing new policies and procedures.
- Education: training directors, principal points of contact, compliance personnel, and third party service providers/delegates.

Resources are available here: [www.ditc.gov.ky](http://www.ditc.gov.ky)
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