

CAYMAN ISLANDS.
CLEARLY BETTER BUSINESS.

FEDERAL INCOME TAX ISSUES

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AGENDA

Insurance Tax Concepts

U.S Tax Reform Considerations

Avrahami v. Commissioner

Tax Issues Raised by IRS Relating to Captives

Foreign Excise Tax

State Developments

INSURANCE TAX CONCEPTS

What qualifies as insurance for tax purposes?

DEFINITION OF INSURANCE

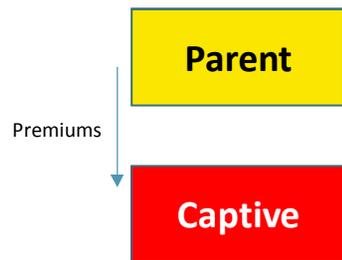
“Insurance” is not defined by the US Internal Revenue Code (IRC) or the US Treasury Regulations

A judicial precedent, as well as a number of subsequent court cases, identifies the following criteria as providing a “framework” for evaluating whether transaction qualifies as insurance:

- “ Presence of insurance risk - *Helvering v. Le Gierse* (1941), *RVI* (2015)
- “ Risk shifting - *Humana* (1989), *AMERCO* (1991)
- “ Risk distribution - *Rent-a-Center* (2014), *Securitas* (2014)
- “ Commonly accepted notions of insurance - *RVI* (2015)

COMMON CAPTIVE STRUCTURES

Parent/subsidiary risks



Parent

Parent is deemed not to have shifted its risk to Captive (balance sheet approach).

Premiums paid from Parent to Captive are not deductible.

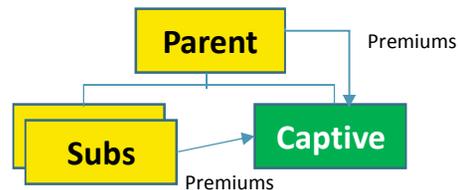
Subs

N/A

Captive

Captive is not considered an insurance company.

Brother/sister risks



Parent

Parent is deemed not to have shifted its risk to Captive (balance sheet approach).

Premiums paid from Parent to Captive are not deductible.

Subs

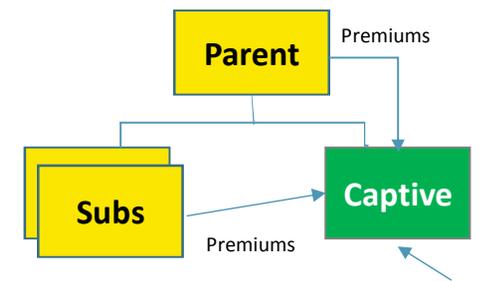
Subs shift risk to Captive.

Premiums paid from Subs to Captive are deemed deductible provided: premiums are arm's-length, the Captive is adequately capitalized, the Captive is not fully backed and risk distribution is present.

Captive

Generally treated as an insurance company.

Third-party risks



Parent

Parent deemed to have shifted its risk to Captive, provided sufficient third-party risk is present.

Third-party risk benchmark >

50% / 30% of total premium.

Premiums paid from Parent to Captive are generally deductible, provided bona fides are satisfied.

Subs

Subs shift risk to Captive.

Same as brother/sister risks

Captive

Generally treated as an insurance company.

U.S. TAX REFORM

Recent developments and the impact on the captive industry

OVERVIEW

Comprehensive tax reform is likely with Republican control

Recent developments

- “ House passed Senate version of the 2018 budget resolution on October 26 by a 216-212 vote
- “ House tax bill released November 2

Republican party not unified as shown in healthcare reform

Senate rules require budget reconciliation to avoid 60-vote requirement

- “ Currently 52 Republicans and Republican VP with tie-breaking vote
- “ Must be 10-year budget neutral

Slides finalized November 7, 2017 with tax reform updates expected

HOUSE BILL . U.S. TAXPAYERS

Beginning in 2018:

- “ Corporate rate reduction to flat 20%
- “ Repeal corporate AMT with various credit refund provisions

P&C companies

- “ Proration modification from 15% to 26.25%
- “ Discounting loss reserves
 - “ Replacing the mid-term applicable Federal rate with the higher corporate bond yield (as specified by Treasury)
 - “ Generally applying the rules for determining loss payment pattern period of long-tail lines to all lines of business
 - “ Repeal elections to use company payment patterns and instead use
- “ Repeal of special estimated tax payments

Life companies face various technical changes including tax reserving

General

- “ Elimination of a number of social policy+tax credits
- “ Deferred compensation considerations

HOUSE BILL . FOREIGN CORPORATIONS

Modifying the current worldwide taxation system:

- “ Exempt from U.S tax dividends from foreign subsidiaries paid from foreign earnings
- “ Tax potentially significant amounts of foreign income on a current basis under anti-base erosion provisions and modifications to Subpart F

Restriction on insurance business exception to Passive Foreign Investment Company (PFIC) rules

- “ Foreign corporation is generally not a PFIC if it is predominantly engaged in the active conduct of an insurance business and would be taxed as an insurance company were it a U.S. corporation
- “ Bill amends exception to apply only if the foreign corporation would
 - (a) be taxed as an insurance company were it a U.S. corporation **AND**
 - (b) if loss and loss adjustment expenses, unearned premiums, and certain reserves constitute more than 25% of its total assets (or 10% if due solely to run-off-related or rating-related circumstances involving the insurance business)

HOUSE BILL . FOREIGN CORPORATIONS

Excise tax / Base erosion

- “ Currently foreign corporations not engaged in U.S trade or business not subject to U.S income tax with 30% withholding of U.S.-source FDAP income and excise tax imposed on premiums paid to reinsurer of 1%
- “ Proposed 20% excise tax for deductible payments (other than interest) from domestic to related foreign corporation
- “ Option to elect to treat the payments as effectively connected income with the conduct of a U.S. trade or business
- “ Applies only to international financial reporting group with payments totaling at least \$100M annually

Subpart F

- “ U.S. corporation would be treated as constructively owning stock held by its foreign shareholder when determining CFC status
- “ Elimination of requirement that corporation must be controlled for 30 days before Subpart F inclusions apply

AVRAHAMI V. COMMISSIONER (149 T.C. NO. 7)

What happened and what is the industry impact?

FACTS

- “ Mr. and Mrs. Avrahami own jewellery stores and other businesses in Arizona, which are treated as flow-through entities for federal tax purposes
- “ With the help of promoters, the Avrahamis formed Feedback Insurance Company Ltd. in 2007 to insure multiple risks of their businesses
- “ Feedback is domiciled in St. Kitts and filed both Section 953(d) and Section 831(b) elections to be treated as a U.S. taxpayer only taxed on its investment income
- “ Feedback entered a quota share reinsurance program with Pan Am Re and accepted pooled terrorism risk of unrelated third parties that accounted for approximately 30% of its premium revenue
- “ Insurance costs of Avrahami businesses increased from \$150k in 2006 to \$1.1 million in 2009 and \$1.3 million in 2010 and were all deducted under Section 162
- “ No claims were filed with Feedback or Pan Am Re in 6 year span until under IRS exam in 2013
- “ Related party transfers between Feedback and Avrahami entities (without regulator approval) comprised the majority of Feedback's assets

COURT VIEW - RISK DISTRIBUTION

Captive must have large enough pool of unrelated risks

- “ Feedback insured only three or four entities

Court determined Pan Am Re is not a *bona fide* insurance company so Feedback cannot rely on the unrelated risk through pooling arrangement

- “ Circular flow of funds
- “ Utterly unreasonable premiums

Court held that:

- “ Policies Pan Am Re issued were not insurance
- “ Feedback's reinsurance of those same policies did not distribute risk
- “ Therefore, Feedback did not have sufficient risk distribution through its affiliated entities nor Pan Am Re

COURT VIEW - COMMONLY ACCEPTED NOTIONS OF INSURANCE

Regulation

- “ Did not seek regulatory approval for related party transactions

Reasonableness of premiums

- “ Actuary determined premiums based on applications, financial, tax returns, business plan, and professional judgment without coherent explanations
- “ The court held that actuary's claims not sound and excessive

Payment of claims

- “ Claims filed against Feedback once IRS began examinations

Feedback does not look like an insurance company

OPINION

Avrahami entities not entitled to deduct premiums paid to Feedback and Pan Am Re

Feedback's elections under Section 831(b) and Section 953(d) were invalid

Related party income on transfers of \$500k to be reported by Avrahamis as taxable income

Accuracy-related penalties

- “ Underpayments of tax considered ~~substantial~~ under Section 6662(a)
- “ Court declined to impose penalties on the deductibility of premiums as the Avrahamis acted on advice in good faith
- “ Penalties still imposed on unreported related party income

IMPLICATIONS

Fact-specific nature of opinion does not provide bright line on insurance company qualification

Risk shifting and insurance risk were unaddressed as failing any one criteria provides grounds for disqualification

Best industry practices:

- “ Requirement for arm's length pricing
- “ Focus on traditional coverage
- “ Compliance with regulatory requirements of chosen domicile
- “ Reasonably priced premiums
- “ Claims timely filed and properly reviewed and approved

Tax Court showed that appropriate documentation, adherence to industry standards, and intent to establish and run a bona fide insurance company should be the backbone of every captive structure

IRS CONCERNS ON CAPTIVES

Coverages, Premiums, Claims & Losses, Investments, and Risk Pools

IRS CONCERNS - COVERAGES

Coverage does not match genuine risks/needs of the insured's particular industry

Coverage is implausible or unnecessary

“ Ideally it would replace commercial policies

Terms of coverage such as scope, exclusions, conditions, sub-limits, etc., must be sensible (not improbable or outlandish)

Risks covered more likely business rather than insurance risks

“ Example: Erosion of profits due to unexpected level of inflation

IRS CONCERNS - PREMIUMS

Premium determined without analysis/underwriting of actuarial historical data consistent with industry standards

For standard coverages, premiums determined without reference to market comparables

Premiums exceeding market pricing without:

- “ Sound underwriting
- “ Factual or actuarial justification

Actuary has a “micro-captive practice” with work product that appears result-oriented

Premiums geared to a specified premium (*i.e.* tax deductible) amount

Premium allocation

- “ Not in accordance with affiliates' relative risk exposures
- “ To affiliates but are not collected from them

IRS CONCERNS - REGULATION & INDUSTRY STANDARDS

Captive does not comply with state captive insurance regulatory requirements such as:

- “ Standalone GAAP audit
- “ Filed business plan

Policies and binders issued and premiums collected later than industry standards

Board actions, authorization/execution of contracts, etc. not contemporaneously documented in minute book

Captive capital inadequate for level of risk assumed

IRS CONCERNS - CLAIMS & LOSSES

Claims administration not consistent with insurance industry standards and business norms

Claims not filed for each loss

Claims reimbursement

- “ Without adequate proof of loss
- “ Not on a timely basis

High level of expectation of no loss coupled with unlikely purchase by insured if coverage were provided by an unrelated party

IRS CONCERNS - INVESTMENTS

Investments atypical for an insurance company

Investments illiquid, speculative or appear to recycle captive's cash to related parties

Loans in material amounts bearing unusual interest rates

Loans to:

- " Insureds
- " Affiliates
- " Principals

Pledge of captive's assets for their benefit

IRS CONCERNS - RISK POOLS

No realistic non-tax business purpose for insurance or affiliates

Premiums don't reflect level of risks ceded/assumed by captive to/from pool

Pool provisions result in substantially all loss allocation to a related party

Primary/reinsurance policies containing exclusions or conditions all but eliminating risk of loss

Primary/reinsurance policies containing provisions appearing to match a captive's claims payouts to amount of premiums received from policyholder

QUESTIONS?

CAYMAN ISLANDS.
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THANK YOU

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