

US Taxation of Captives: Part I – Taxable Owners

By Tom Jones

This is the first of two articles summarizing current U.S. taxation of captives and their owners. This article focuses on captives owned by taxable entities and individuals. The second article will consider captives wholly or partially owned by tax-exempt organizations. We chose to bifurcate the two topics because of the fundamental differences in tax implications between the two types of owners. For instance, taxable owners generally strive to achieve “insurance company” status for their captives. Tax-exempt owners, in contrast, generally try to avoid having their captives being classified as “insurance companies.” Their reasons should be explained separately. Our ambitious objective is to describe in plain English the basics of how captives and their owners are taxed by the United States and its political subdivisions. You may be relieved that no Internal Revenue Code (IRC) provisions or Internal Revenue Service (IRS) rulings are cited by number, and only a few key cases are mentioned by name. Be aware, however, that generalizations have numerous exceptions, and the ideal use of this information is to enhance your ability to ask more targeted questions of your tax adviser. Although taxation of “cell” captives, “rent-a-captives,” and other “exotic” structures are not discussed in detail, the general principles described in this article also are applicable in determining how they are taxed.

Presence or Absence of “Insurance” Matters

When forming or participating in a risk financing mechanism, the threshold tax issue is always the same: Is it really “insurance” for federal and state tax purposes? Although economists and insurance academics long ago reached a general consensus on the meaning of the term “insurance,” the tax law definition continues to evolve. Prior to discussing this definition, it is useful to understand why the presence of “insurance” for tax purposes matters.

Benefits of “Insurance” to Taxpayers: Deductibility of Premium Payments

The most obvious advantage of “insurance” status to taxpayers is the ability to deduct the payment to the insurer. To achieve tax deductibility, insurance premium payments must be deemed to be an ordinary and necessary business expense. In contrast, setting money aside in a self-funding reserve earmarked for future contingent losses is not tax deductible because, in effect, the taxpayer is merely moving the funds “from its left to its right pocket.” That is, payments into a reserve fund are generally not deductible until the fund actually pays out money for a loss or for loss adjustment expenses. Although this difference is only one of timing, a taxpayer that is able to accelerate deductions actually benefits from what amounts to an interest-free loan by the government.

A corollary benefit from “insurance” inures to the risk-funding vehicle (e.g., an insurance company) itself. As stated, a regular taxpayer cannot deduct internal loss reserves. However, the IRC affords insurance companies a special statutory advantage. (Note: all references to insurance companies include reinsurance companies as well.) Insurers alone are eligible to take a current tax deduction for a “reasonable and fair” estimate of future contingent losses and loss adjustments expenses (reduced by an IRS-prescribed or experience-derived discount factor to account for the time value of money). So, if a funding vehicle is subject to tax, and if it can be classified as an insurance company, its tax burden will be substantially reduced. This is most pronounced in the case of “long-tail” exposures, where years pass between the premium payment and the claim payout. This loss reserve deduction is beneficial to both onshore and offshore captives. A 2004 IRC amendment confirmed that the same definition of “insurance company” applies to property and casualty (P&C) as to life insurers; namely, that over 50 percent of its business is issuing insurance or annuity contracts, or reinsuring risks of insurance companies.

Offshore captive insurers, furthermore, have two more tax advantages. First, they may voluntarily elect to be taxed in the United States. Sometimes, an

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offshore insurer decides that it prefers to be treated as a domestic taxpayer for tax minimization or compliance simplification reasons. It can do this by making an essentially irrevocable election to this effect. But only true insurance companies are permitted to so elect. Second, by statute, an offshore insurance company is automatically exempted from an onerous tax regime applicable to a passive foreign investment company (PFIC).

Disadvantage of “Insurance” to Taxpayers: Other Taxes.

A disadvantage of falling within the definition of “insurance” is that premiums paid to offshore insurers with respect to U.S. risks are subject to a Federal Excise Tax (FET) (unless a tax treaty applies). The tax is 4 percent of the premium for direct (unfronted) insurance and 1 percent of premium for reinsurance or life business. In addition, the IRS takes the position that the FET applies on a so-called cascading basis, i.e., to multiple insurance and reinsurance transactions covering the same risk. So, for example, under the IRS view, an insured may bear the FET cost of 4 percent of the premium paid to a Bermuda insurer and may then bear an additional FET cost of 1 percent of the premium paid by the Bermuda insurer to reinsure the risk with another Bermuda insurance company. No FET treaty relief exists for the most common offshore captive domiciles—Bermuda or the Cayman Islands. Other countries do enjoy FET relief in treaties, such as the one between the United States and Ireland. Further, many states impose a special type of premium tax, often called a “direct placement” or “self-procurement”

tax, applicable to insurance premiums paid to both onshore and offshore captives that are not licensed in the taxing state. In many (but not all) cases, this tax is not applicable if no “insurance” exists such that the payment, at least arguably, is not really a “premium.”

The Evolving Tax Definition of “Insurance”

The Need for Risk Shifting and Risk Distribution

Surprisingly, neither the IRC nor other official pronouncements actually define the term “insurance.” To find “insurance,” both the IRS and numerous courts have required the presence of both risk shifting and risk distribution. Risk shifting connotes the transfer of risk to a separate party, e.g., the financial consequences of the potential loss are shifted from the insured to the insurer. Risk Distribution mandates that enough independent risks of unrelated parties be pooled to invoke the actuarial law of large numbers, e.g., each insured’s risk exposures are spread among premiums paid by other insureds so that a particular insured is not funding its own losses. In 1977, the seminal IRS revenue ruling on risk shifting was released in which the “economic family” doctrine was enunciated, denying premium and loss reserve deductibility to a single-parent captive covering risks of only the captive’s parent and its subsidiaries. (The IRS has since abandoned the “economic family” doctrine—discussed below—but continues to apply the principles outlined in that ruling to challenge arrangements where the captive covers only its parent’s risk or where the facts

and circumstances otherwise indicate that the purported insured has not in fact transferred risk.) A year later, the IRS conceded that if a sufficient number of unrelated parties pool their loss exposures (31 in the ruling), then sufficient risk distribution exists to create “insurance.” In 2002, the IRS released a group captive ruling indicating that as few as 7 equal owners should suffice to create a bona fide insurance company.

Unrelated Risk

In practice, courts have concluded that insurance is present if a single parent captive writes significant unrelated business. That is, the courts have determined that if a captive covers a sufficiently large percentage of “unrelated risks,” then the entire risk pool should be treated as an insurance company. This judicial rule derives from three appellate cases decided contemporaneously against the IRS and for the taxpayer in 1992. In the first case, the IRS alleged that Allstate was not an “insurance company” relative to its then parent, Sears, notwithstanding that well over 99 percent of Allstate’s insureds were completely unrelated parties. In a companion case involving the Harper Group, only 29 percent of the retained premiums were (in one of the years under audit) attributable to unrelated parties. In both cases, the taxpayer prevailed. IRS guidance issued in 2002 provides that where only 10 percent of the premiums are attributable to unrelated parties, the arrangement lacks the requisite risk shifting and risk distribution to constitute insurance for tax purposes. However, where 50 percent or more of the premiums are attributable to unrelated risks,

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the requisite risk shifting and risk distribution are present. From these cases and administrative guidance—and with a considerable degree of trepidation—the unofficial rule of thumb for finding enough risk transfer and risk distribution to support a finding of “insurance” is at least 30 percent (the closer to 50 percent the better!) unrelated (third-party) retained premium.

Brother-Sister Risk

While the battle over unrelated risk was underway, an ingenious lawyer for Humana Corporation in 1986 presented to the court a then novel theory that a captive’s coverage of brother-sister corporations, although under common ownership by the parent, could result in a finding of “insurance.” Building on a longstanding tax principle that separate corporations should be treated separately in spite of their common ownership, the argument was that risk indeed had been distributed among the numerous sister subsidiaries of the captive even though they belonged to the same economic family. Although the Tax Court initially rejected this approach, the Sixth Circuit Court of Appeals accepted it, and other circuit courts subsequently have cited this case with approval. In addition, the U.S. Court of Federal Claims in Washington concurred and, in so doing, gave the theory national viability. The IRS, recognizing that the courts had rejected the economic family doctrine, announced in 2001 that it would no longer invoke the theory with respect to captive insurance transactions. Shortly after that announcement, the IRS released additional guidance in

the form of a revenue ruling which concluded that an arrangement in which a captive insurance company provided professional liability coverage to 12 brother-sister subsidiaries constituted “insurance” where none of the subsidiaries accounted for liability coverage of less than 5 percent, nor more than 15 percent, of the total risk insured by the captive insurance company. Recent guidance, however, cautions that the 12 brother-sister subsidiaries must be “regarded” entities—as contrasted with entities that are treated as a division of their parent entity, often referred to as a “tax transparent” or “disregarded entity.” A Federal Claims Court decision rejected the notion that divisions of a corporation should be treated as if they were separate corporations for this purpose. So, siblings of even a single-parent captive—if there are enough of them, the risk spread among them is adequate, and they are regarded entities—can deduct premiums paid to the captive (although the parent itself cannot) and, further, the captive can deduct loss reserves attributable to the siblings.

Partnerships and S Corporations

As discussed above, at least according to the IRS, disregarded or tax transparent entities (such as limited liability companies with only one member) are treated as branches of a parent entity and are not treated as separate entities for purposes of assessing risk shifting and risk distribution. What about partnerships and S corporations? These types of entities are similar to disregarded entities from a tax perspective, e.g., partnership income

flows through to its partners, and S corporation income flows through to its shareholders. In the partnership area, the determination of whether the entity or the owner is the insured may depend on the state law form of legal entity. For example, a partnership that is organized under a state limited partnership law is not necessarily the insured. In that instance, the IRS may view the general partner as the insured because under state law, the general partner is ultimately liable for the partnership’s obligations. As a result, in the insurance arrangement, it is the general partner whose risk is shifted. In contrast, a partnership that is organized under a state law limited liability company act may itself be viewed as the insured because, under state law, no liability attaches to anyone other than the limited liability company itself. A similar result would arise with regard to corporation that has elected special tax treatment under Subchapter S of the IRC—while the owners, rather than the corporation, are taxed on corporate earnings, no liability attaches to anyone other than the corporation itself. As a result, the insured would be the corporate entity and not the shareholders.

Onshore versus Offshore

For a tax planner, the basic dichotomy in captive domicile selection is onshore versus offshore. Nontax business factors often rightly predominate in making the “proper” choice. In fact, the United Parcel Service (UPS) tax case underscores the critical importance of documenting the business reasons motivating the decision to form a captive. Moreover, in recent years, the courts and the IRS have focused on the “economic substance” of

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transactions, i.e., does the transaction have a substantial nontax purpose, and does it meaningfully affect the parties' economic positions. Very recently, the "economic substance" doctrine was codified in the IRC thus highlighting the continued emphasis on the taxpayer's business motivation. The conventional wisdom has been that offshore insurance regulation, for example in Bermuda and the Cayman Islands, generally is more flexible and reporting requirements are less stringent than onshore. Given that over 30 captive-friendly states now compete for captive business, however, great strides have been made by American domiciles in accommodating the ever-changing uses and objectives of captives and their owners. A few fundamental tax principles will assist in analyzing domiciles for the optimal tax outcome:

1. Any risk pool sharing sufficient exposures to constitute "insurance"-whether in the legal form of a trust, partnership, or limited liability company-is taxed as a corporation.
2. Corporations formed under the law of any U.S. state generally are subject to federal income tax on worldwide income.
3. An offshore corporation is itself taxable in the United States only if it conducts business in the United States. A narrow exception, mentioned above, is that if the offshore corporation is an "insurance company," it can voluntarily elect to be taxed as a domestic corporation. But most offshore captives diligently avoid engaging in a U.S. business (see below), both to escape federal

income tax at the captive level and to stay out of state insurance regulatory trouble. (As "alien" insurers without a certificate of authority from any state, they are prohibited from conducting an insurance business onshore.)

Taxation of Offshore Captives

Despite misperceptions among the general public, offshore captive insurance programs generally are subject to annual federal income taxation, even though taxation by the host domicile may be light or nil. Five major tax areas include:

- Imputed federal income tax imposed on the shareholders of a controlled foreign corporation (CFC)
- Related person insurance income (RPII) CFC Rules
- Branch profits tax
- Federal withholding tax
- Federal Excise Tax (discussed above)

CFCs and "Subpart F" Provisions

An offshore captive, if controlled by U.S. persons or if writing a significant amount of risks of its U.S. owners, is subject to a complex imputed federal income tax regime imposed on CFCs under the "subpart F" provisions of the IRC. In general, subpart F provides that each U.S. shareholder owning 10 percent or more of the voting power of a CFC (after taking into account complex attribution rules) will be taxed annually on its pro-rata share of the undistributed insurance income attributable to risks outside its country of incorporation. An insurance company is a "regular" CFC if such U.S. shareholders collectively own 25 percent or more of the voting

power or value of the foreign captive. The purpose of imputing the foreign captive's income to its U.S. owners is to prevent U.S. shareholders (or policyholders in the case of a mutual company) from deferring U.S. tax by accumulating such income offshore in a no-tax or low-tax jurisdiction. Double taxation of this income is avoided by allowing the foreign captive to pay actual cash dividends subsequently without additional tax. If the foreign captive is an "insurance company," subpart F income will be computed in essentially the same basic way in which a domestic insurance company computes its taxable income. That is, the U.S. shareholder will be taxed currently on net underwriting and investment income, calculated using U.S. tax accounting rules, earned by the foreign captive after deduction of "fair and reasonable" discounted loss reserves. If the foreign captive does not qualify as an "insurance company," then it generates only investment income, and it may be subject to the PFIC provisions mentioned above. Some offshore insurance company captives avoid the CFC subpart F provisions by making the voluntary onshore tax election previously described. They thereby become eligible (subject to restrictions on use of tax losses) to join in the parent's federal consolidated income tax return. These offshore captives are usually controlled affiliates of multinational corporations. Why would they choose this election? To avoid having to pay the Federal Excise Tax on premiums, a possible 30 percent "branch profits" tax, and a 30 percent withholding tax (the latter two to be described below).

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RPII CFC Rules

In addition to the “regular” CFC definition, special provisions apply to certain offshore insurance companies, mainly group-owned captives. The effect is to tax all U.S. shareholders (regardless of captive ownership percentage) annually on their share of the captive’s undistributed income attributable to insuring parties related to the captive’s owners. These related RPII CFC rules, which vastly expand the net of subpart F where captive owners and insureds overlap, apply whenever the following three criteria are satisfied:

- RPII represents 20 percent or more of the captive’s insurance income;
- Twenty percent or more of the voting power or value of the captive’s shares is directly or indirectly owned by its insureds or their affiliates; and
- U.S. shareholders (without regard to the 10 percent minimum ownership requirement for “regular” CFCs) own 25 percent or more of the voting power or value of the captive’s shares for at least 30 consecutive days in a taxable year.

Branch Profits Tax

Offshore captive income “effectively connected” with its U.S. trade or business may be subject not only to “mainstream” corporate tax (currently at a 35 percent statutory rate), but also to a second layer of tax. The branch profits tax is imposed at a rate of 30 percent on net earnings attributable to the captive’s U.S. trade or business which are not retained in that business. “Effectively connected” income is that income effectively derived from doing business in the United States (whether purposeful or inadvertent).

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Federal Withholding Tax

Finally, offshore captives should not lose sight of the 30 percent federal “withholding” tax (a misnomer as it is non recoverable) on passive income such as interest and dividends emanating from a U.S. source. This tax makes “loanbacks” from offshore captives to U.S. parents more expensive because it applies to the actual or imputed interest on such related party loans. This tax usually is avoidable on fixed income securities owned by the foreign captive, under the “portfolio interest” exemption, but it applies to dividends on equities of U.S. issuers, although not to American Depositary Receipts (ADRs) of foreign issuers. More complex rules apply to mutual funds (including bond funds) that usually are treated as generating dividends. For this reason, many offshore captives invest in offshore “clone” funds that escape withholding tax under the tax treaty between the United States and their country of formation (often Ireland or Luxembourg).

How to Avoid U.S. Business.

Most offshore captives strive to avoid being found to be

“engaging in a U.S. trade or business” because the captive itself (rather than its U.S. shareholders) then will become subject to U.S. corporate tax on income “effectively connected” with its U.S. business. Many steps can be taken to avoid engaging in a U.S. trade or business. Common techniques include the following:

- Carrying on as many activities as possible outside the United States
- Not qualifying to do business under the corporate laws of any state

- Conducting daily operations through offshore management personnel (usually by contract with a captive management organization) located outside the United States
- Holding all board of directors meetings (including committees) and executing all contracts outside the United States
- Drafting the captive policies in an “indemnity” rather than “pay on behalf of” format with a clause shifting duty to adjust and settle claims to the indemnified Party
- Having a deductible or self-insured retention such that the onshore party has the first-dollar loss exposure

If there is an income tax treaty in force between the United States and the captive’s domicile, as is the case with Bermuda, then the issue becomes whether the insurance company has income “attributable to” a U.S. “permanent establishment.” In general, the treaty rules allow a somewhat broader range of activity before sufficient nexus for direct U.S. income taxation exists. A frequently overlooked safeguard is to cause the offshore captive to file an annual protective IRS Form 1120-F to eliminate the possibility (as permitted in the IRC) that it might be taxed on gross income (without benefit of deductions or credits). This return need not disclose information other than the name, address, and Federal Employer Identification Number of the captive.

Taxation of Onshore Captives

Because a domestic captive is itself subject to tax on worldwide income, no imputation system like the subpart

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F provisions is necessary. Domestic “insurance company” captives can deduct discounted loss (and unearned premium) reserves when calculating their taxable underwriting and investment income. As with an eligible offshore captive electing onshore tax treatment, a domestic captive at least 80 percent owned (measured by voting power and value) by another domestic corporation can be included in the federal consolidated income tax return of its parent. Although this inclusion causes the premium deduction and taxable premium income to “wash out” in the consolidation, the discounted loss reserve deduction survives to reduce consolidated taxable income of the group.

Miscellaneous Tax Considerations

Other factors can militate against a captive’s status as a true insurance company. A few of the most prominent include the following:

- Undercapitalization or promise of additional capitalization (sometimes called “accordion” capitalization) of the captive
- Parental guarantees or comfort letters in favor of the captive or its “fronting” insurer
- Excessive use of “loanbacks” of captive assets to its parent
- Captive policies that do not transfer risk, for example, because policy limits are certain to be exceeded (i.e., policies that are more like banking or deposit transactions than insurance contracts)
- Cell or “Chinese Wall” sub-account structures (whether by statute or contractual) designed to prevent risk sharing. (Definitive guidance in this area is expected.

In the interim, in 2008, the IRS published a ruling considering the deductibility of premiums paid to a cell company. The guidance applied the risk shifting and risk distribution principles outlined in this article to a single cell of the cell company as if it were a separate taxpayer and not a division of a cell company. Proposed Treasury Regulations issued in September 2010 provide additional guidance. The Proposed Regulations generally treat each cell as a separate taxpayer--applicable to U.S. cells and to non-U.S. cells that conduct an insurance business. Thus, the Proposed Regulations are consistent with the IRS guidance and support application of the risk shifting and risk distribution principles to the cell as a separate taxpayer. The Proposed Regulations also provide transition rules that generally permit a cell to be treated together with the other cells in the cell organization and with the cell organization itself as a single entity until a change in ownership of 50 percent or more of the cell organization (or the cell.)

Key Tax Points to Remember

To reinforce your recall of captive tax basics, here are a few key tax principles in condensed form:

- “Insurance” is not specifically defined in the tax law and, therefore, its meaning is derived (and will continue to evolve) mainly from case law and IRS pronouncements.
- The touchstone of “insurance” is risk shifting and risk distribution.
- Existence of “insurance” is important, not just to accelerate a tax deduction to the time the

premium is paid from the time the claim is paid, but to allow the risk pool to deduct reserves for estimated losses and unearned premiums.

- Any risk pool constituting “insurance,” regardless of form (trust, limited liability company, unincorporated association, etc.) is taxable as a corporation.
- A longstanding tax maxim is that, absent extraordinary circumstances, each legal person (individual or entity) has an independent and separate identity, irrespective of who owns it or whom it owns.
- Notwithstanding the above maxim, a legal entity that is disregarded or tax transparent, such as a single member limited liability company, will be treated by the IRS simply as a division of its parent and will not be treated as having an independent and separate identity.
- By writing as little as 30 percent or, better, at least 50 percent (measured by net retained premiums) unrelated business, the entire captive can be a true “insurance company.”
- Alternatively, a captive covering a significant number of brother-sister affiliates can be an “insurance company” vis-à-vis those affiliates (but not the parent).

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