TAX CONSIDERATIONS FOR TAXABLE ENTITIES

Mike Domanski
Partner
Honigman Miller
Schwartz and Cohn LLP

T.C. Leshikar
Partner, Tax
PwC Cayman Islands

CAYMAN CAPTIVE FORUM 2018

AGENDA

- Insurance vs. Non-Insurance
- Offshore Federal Tax Considerations
- Controlled Foreign Corporations
- Insurance Company Taxation
- Federal Excise Tax
- 953(d) and 831(b) Elections
- U.S. Tax Reporting Requirements
- Recent Developments

INSURANCE VS. NON-INSURANCE

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INSURANCE VS. NON-INSURANCE

- No statutory or regulatory definition of "insurance" - only cases and rulings
- To find insurance, the IRS and the courts have historically required the presence of both risk shifting and risk distribution
- Supreme Court stated that "historically and commonly, insurance involves risk shifting and risk distributing."
- In addition to risk shifting and risk distribution, the IRS and the courts have also looked at the whether the covered risks are "insurance risks" and if the structure reflects insurance in the "commonly accepted sense"

INSURANCE VS. NON-INSURANCE

- **What is an “insurance” risk?**
- **Qualitative and quantitative tests**

Qualitative

- Sufficient fortuity?
- Business risk?
- Investment risk?

Quantitative

- Risk transfer tests for frequency and severity risks
- Do premiums plus investment income equal total exposure under the policy?

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INSURANCE VS. NON-INSURANCE

What is an "insurance" risk?

- **IRS tends to prefer "traditional" risks**
  - Professional liability
  - General liability
  - Property
- **IRS views many "non-traditional" risks as business risks, not insurance risks**
- **Courts have not yet made a distinction between business and insurance risks**

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INSURANCE VS. NON-INSURANCE

- **Captive arrangement must reflect "commonly accepted notions of insurance"**
- **What does that mean exactly?**
  - The captive is regulated as an insurance company
  - The captive issues contracts / policies of insurance
  - The captive is formed for non-tax business reasons
  - Transactions are priced at an arms-length rate (more scrutiny for related parties)
  - The operational and investment activities of the company should be typical of commercial insurance enterprises

INSURANCE VS. NON-INSURANCE

- **As much as possible, captive must function like a commercial insurance company**
  - Clear and appropriate policy terms
  - Robust actuarial analysis and satisfaction of “risk transfer” tests
  - Approvals from local regulators for material transactions
  - Well-balanced investment strategy – combination of debt and equity positions, liquid assets
  - Disciplined claims handling procedures

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INSURANCE VS. NON-INSURANCE

Risk Shifting and Risk Distribution

- Risk Shifting to include a passage of loss from an insured to an insurer; a payment of a premium that is less than the risk insured; and an insurer that is financially capable of accepting the risk
- Risk Distribution exists when all of the following are present: the insurer has a sufficient number of exposures for the statistical law of averages to function; the exposures present approximately the same chance of loss; and the exposures are each separate and distinct

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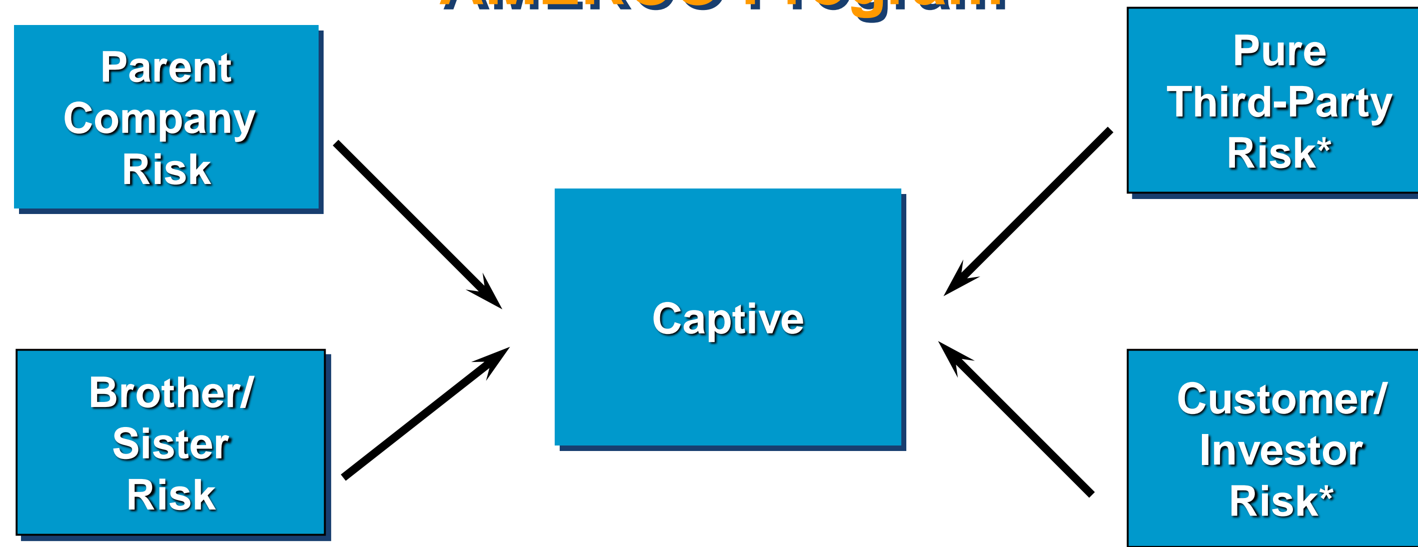
INSURANCE VS. NON-INSURANCE



The Tax Court and Ninth Circuit aggregated customer/investor risk and pure third party risk to test whether captive qualified as an insurance company. The courts did not reach the issue of whether the brother/sister risk was insurance risk because 30% "outside" risk was enough to find "insurance." In Harper Group 30% of premiums were received from unrelated insureds

INSURANCE VS. NON-INSURANCE

Revenue Ruling 2002-89 Unrelated Risk Ruling

- Single parent captive otherwise properly formed and operated (adequate capital, no parent guarantees, loan backs, etc.)
- Not “insurance” if 90% of risks/premiums come from the parent
- “Insurance” if less than 50% come from the parent and the remainder are from unrelated parties

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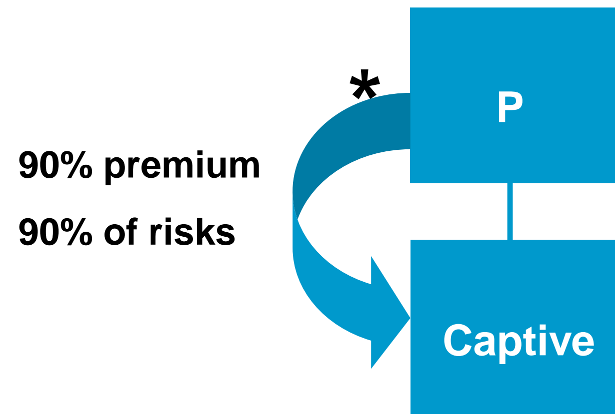
INSURANCE VS. NON-INSURANCE

Revenue Ruling 2002-89

Scenario 1

90% premium

90% of risks

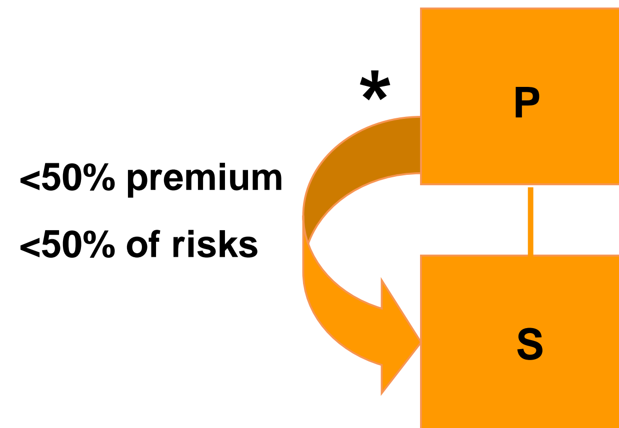


* Not insurance – lacks requisite risk shifting/risk distribution

Scenario 2

<50% premium

<50% of risks



Risks of P pooled with risks of unrelated insureds

* Not insurance – lacks requisite risk shifting/risk distribution

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INSURANCE VS. NON-INSURANCE

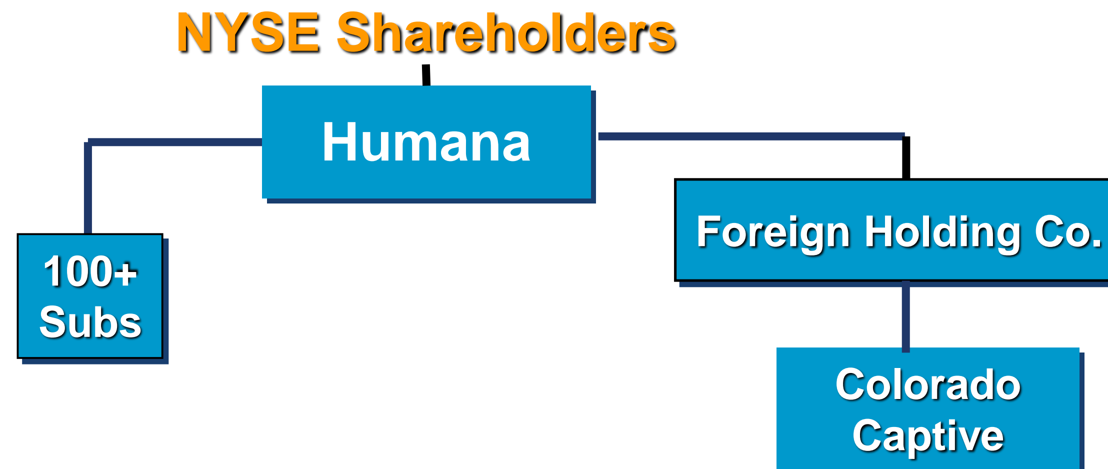
The Brother/Sister Approach - Humana, Inc. v. Comm'r.

- In Humana, the parent of an affiliated group established a captive subsidiary after its coverage was cancelled by a commercial insurance carrier and it was unable to obtain other coverage. The parent paid premiums to the captive, which were calculated by using standard insurance industry practices for itself and its subsidiaries. The parent then charged back to the subsidiaries the payments that it made on their behalf

INSURANCE VS. NON-INSURANCE

The Brother/Sister Approach - Humana, Inc. v. Comm'r.

- No tax deduction for payments from parent to subsidiary
- Tax deductibility of subsidiaries' premiums paid to captive (brother - sister premiums)



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INSURANCE VS. NON-INSURANCE

Revenue Ruling 2002-90 – “Sibling Ruling”

- Single parent captive otherwise properly formed and operated (adequate capital, no parent guarantees, loan backs, etc.)
- Insures 12 domestic subs - parent a holding company; no sub accounts for less than 5% or over 15% of total risk/premium
- “Insurance” under brother/sister doctrine

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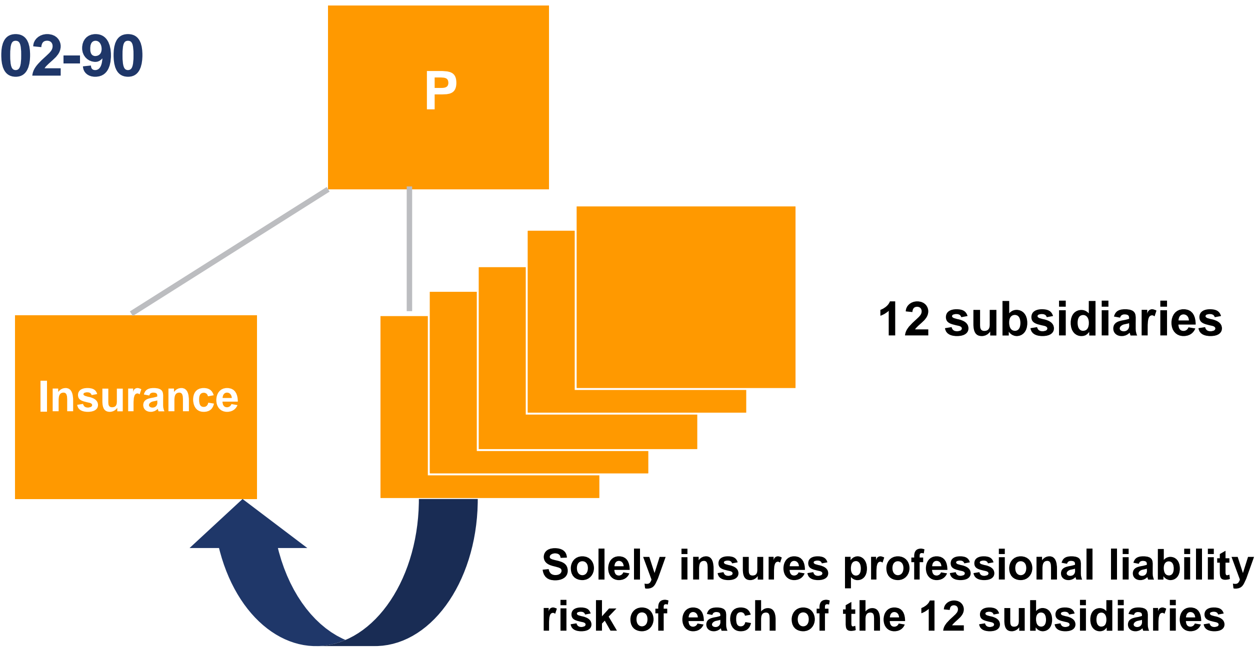
INSURANCE VS. NON-INSURANCE

Revenue Ruling 2002-90



Ruling: Arrangement between Captive and 12 subsidiaries of Captive's parent constitutes insurance. Risk of Parent does not constitute insurance.

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INSURANCE VS. NON-INSURANCE

Revenue Ruling 2002-91 – "Group Captive Ruling"

- Captive constitutes an "insurance company" and premiums paid by participants are deductible
  - Industry group liability captive; exact number of participants not specified
  - No member owns over 15%; has over 15% of vote; or accounts for over 15% of risk/premium; *implies 7 equal owners OK*

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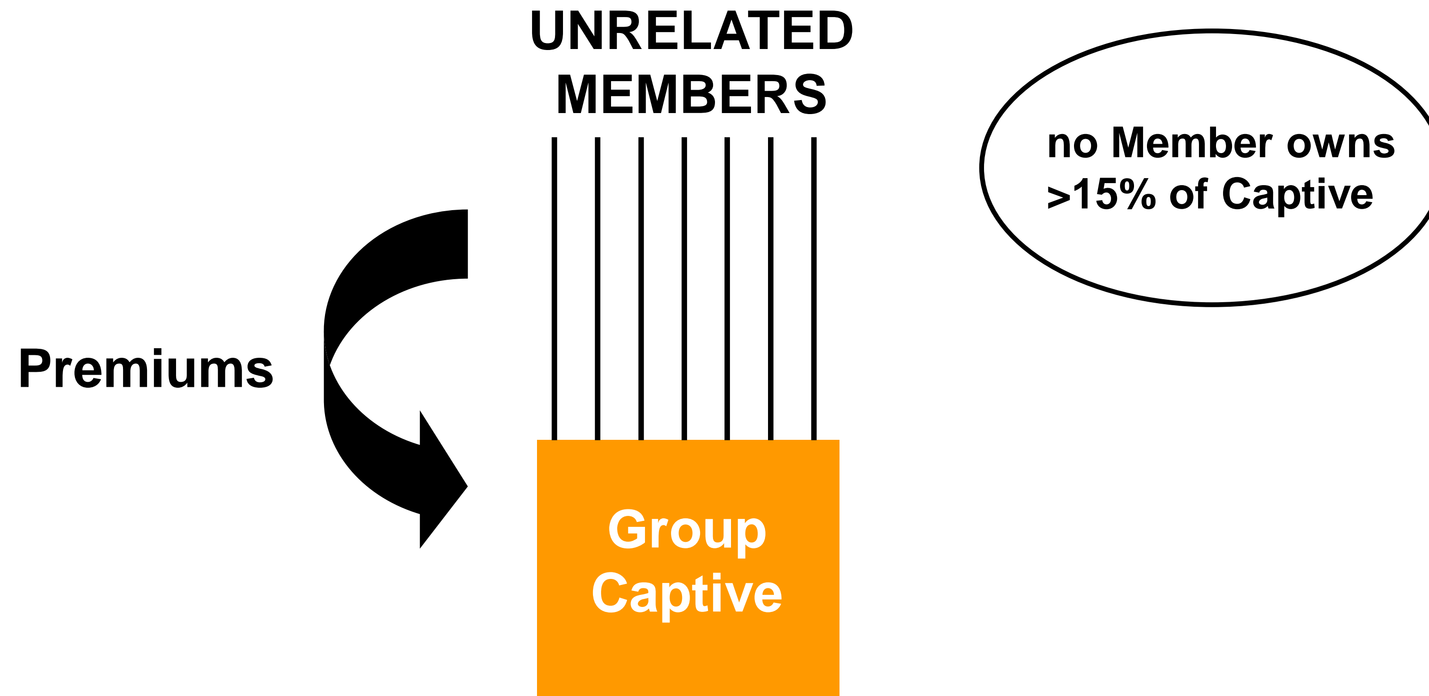
INSURANCE VS. NON-INSURANCE

Revenue Ruling 2002-91 – “Group Captive Ruling”



Ruling: Arrangement, based on facts, held as insurance

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INSURANCE VS. NON-INSURANCE

Revenue Ruling 2005-40

- Do the arrangements described in the following slides constitute insurance for federal income tax purposes?
- The IRS issued guidance emphasizing that the requirement of risk distribution must be met before smaller risk-shifting arrangements qualify as insurance for federal income tax purposes

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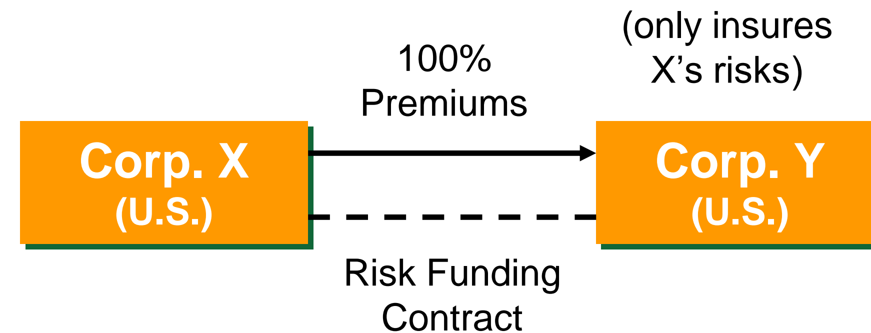
INSURANCE VS. NON-INSURANCE

Revenue Ruling 2005-40

Situation 1

- X owns and operates a large fleet of vehicles
- Vehicles represent a significant volume of independent, “homogeneous” risk
- X enters into an arrangement with unrelated Y where in exchange for “premiums”, Y agrees to “insure” X against risk of loss with respect to X’s vehicle fleet
- Y does not “insure” any entity other than X



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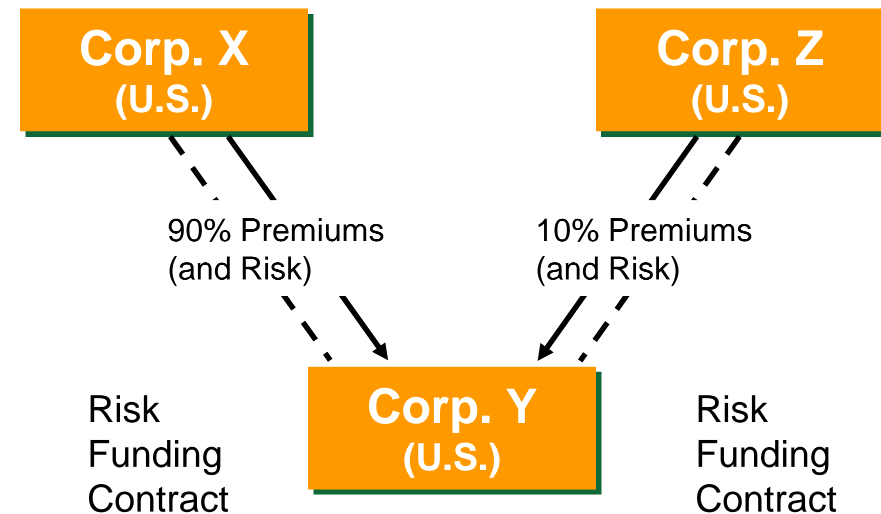
INSURANCE VS. NON-INSURANCE

Revenue Ruling 2005-40

Situation 2

- Same as Situation 1, except that Y also "insures" unrelated Z in exchange for "premiums against risk of loss with respect to Z's vehicle fleet in the conduct of a business substantially similar to that of X
- Y's earnings from its arrangement with Z constitute 10% of Y's total amount earned (both gross and net) during the year and the risk exposure attributable to Z comprise 10% of the total risk borne by Y



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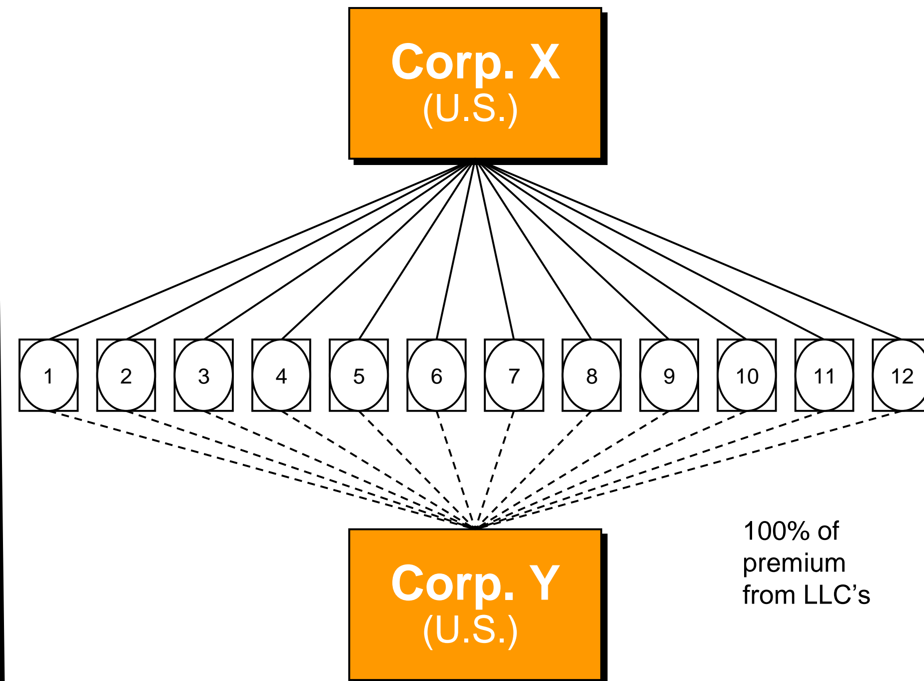
INSURANCE VS. NON-INSURANCE

Revenue Ruling 2005-40

Situation 3

- X conducts a courier business through 12 LLCs that are disregarded entities for Federal Income tax purposes
- The LLCs own a fleet of vehicles that represent a significant volume of independent, homogeneous risk
- Each of the LLCs enters into an arrangement with Y where unrelated Y agrees to "insure" the LLC against risk of loss with respect to its vehicle fleet
- Y does not "insure" any entity other than the LLCs
- None of the LLCs account for less than 5%, or more than 15% of the total risk assumed by Y



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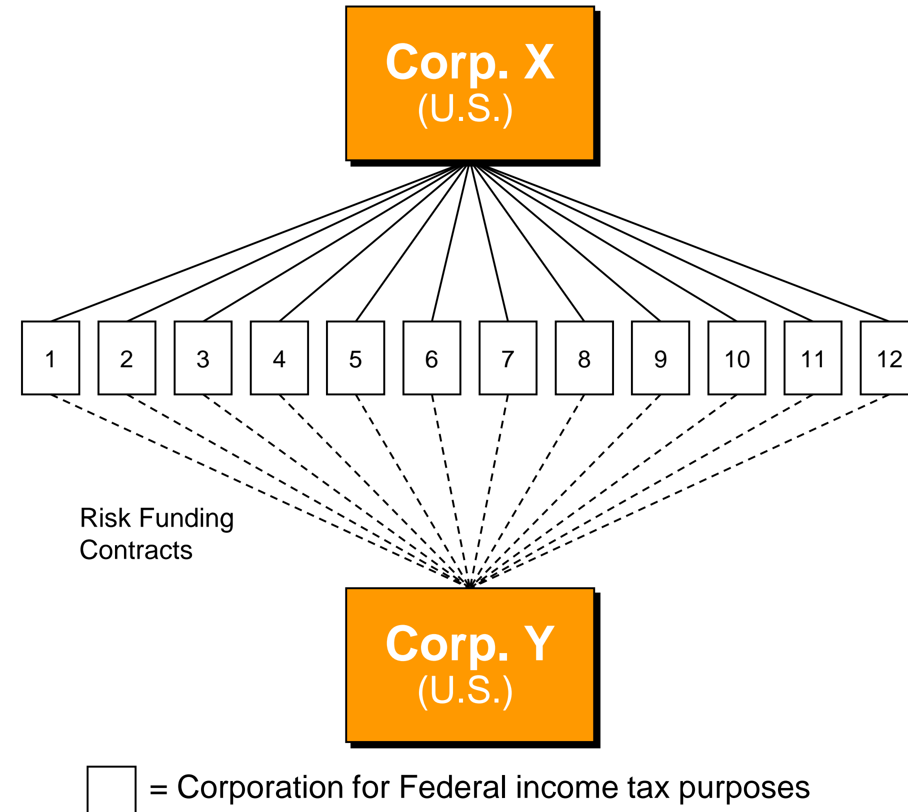
INSURANCE VS. NON-INSURANCE

Revenue Ruling 2005-40

Situation 4

- Same as Situation 3, except that the 12 LLCs elect to be treated as corporations for Federal income tax purposes



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INSURANCE VS. NON-INSURANCE

Revenue Ruling 2005-40

- The IRS concluded that, although each of the arrangements satisfied the risk shifting requirement for insurance status, risk distribution was lacking in Situations 1, 2 and 3. Accordingly, only Situation 4 constituted "insurance" from a Federal income tax perspective.
- The IRS did not, however, provide a clear indication of the manner in which Situations 1, 2 and 3 should be treated for Federal income tax purposes.

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OFFSHORE FEDERAL TAX CONSIDERATIONS

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Offshore captive tax issues include:

- Imputed federal income tax on controlled foreign corporations (“Subpart F” income)
- Related party insurance income (“RPII”)
- Branch profits tax
- Federal withholding tax
- Federal excise tax
- A qualifying “insurance company” can opt out of foregoing by electing taxation as a domestic entity

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OFFSHORE FEDERAL TAX CONSIDERATIONS

Avoidance of U.S. Trade or Business

- A factual determination
- Determined each tax year
- Main factors are continuity, regularity and substantiality of captive's U.S. activities
- Management situs test - where is captive's "mind and management?"
- Activity of employees and dependent agents attributed to captive; not independent agents

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CONTROLLED FOREIGN CORPORATIONS

CONTROLLED FOREIGN CORPORATIONS

- A foreign corporation is a Controlled Foreign Corporation ("CFC") if, on any day during its tax year, U.S. shareholders own more than 50% of the combined voting power of all classes of stock, or more than 50% of the total value of the corporation
- A U.S. Shareholder is any person owning at least 10% of the total combined voting power of all classes of stock of the foreign corporation or 10% of the total value of the corporation (2017 Tax Reform Change)
- A company is an insurance CFC if its 10% U.S. shareholders own more than 25% of the vote or value of the foreign corporation

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CONTROLLED FOREIGN CORPORATIONS

RPII – Related Person Insurance Income

- Another rule applies for purposes of allocating insurance income derived from the insuring of related parties (“related person insurance income”); here, all U.S. shareholders, not just 10% or more voting, are included for purposes of the 25% test.
- Thus, if a foreign captive is a CFC, the U.S. shareholders must include in taxable income their pro rata share of the CFC's Subpart F insurance income, thereby negating any deferral of such income, whether or not repatriated

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CONTROLLED FOREIGN CORPORATIONS

Subpart F

- Subpart F requires every person (and entity) that is a U.S. shareholder of a CFC, and owns stock in the corporation on the last day of the CFC's tax year, to include in gross income a deemed dividend equal to the shareholder's pro rata share of the CFC's “tainted earnings,” which includes “insurance income.”
- Subpart F applies only to a CFC.

CELL CAPTIVES

Federal Tax Treatment of Cells

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

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INSURANCE COMPANY TAXATION

INSURANCE COMPANY TAXATION

- **How is the captive taxed?**
- **If the captive qualifies as an insurance company for tax purposes, the taxable income will be calculated pursuant to the insurance company provisions of the U.S. tax code.**
  - Tax adjustments
  - Loss reserves discounting (2017 Tax Reform Change)
  - 20% haircut for unearned premiums
  - Deferred acquisition costs - when a company defers the sales costs that are associated with acquiring a new customer over the term of the insurance contract.

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FEDERAL EXCISE TAX

FEDERAL EXCISE TAX ("FET")

- **Applies to premiums paid to foreign insurers/reinsurers covering U.S. risks**
  - 4% on "direct" property & casualty policies
  - 1% on life policies and all reinsurance
- **Withheld and remitted (quarterly on IRS Form 720) by payer of premium**
- **If not a deductible "insurance" premium, then FET N/A - Rev. Rul. 78-277**
- **Also N/A if onshore tax election is made or tax treaty applies (e.g., Ireland, UK, Germany, Switzerland)**
- **Cascading FET recently overturned (due to IRS loss in *Validus* case)**

953(D) & 831(B) ELECTIONS

953(D) & 831(B) ELECTIONS

953(d) Election

- Election is irrevocable
- Captive becomes a U.S. domestic corporation for all purposes of the U.S. tax code
- LOC requirement if not sufficient U.S. assets
- Captive files U.S. tax return and pays income tax (Form 5471 no longer required for shareholders)

953(D) & 831(B) ELECTIONS

953(d) Election

- Eliminates U.S. trade or business concerns
- State regulatory concerns still exist
- There are two levels of U.S. tax on corporate earnings. However, the effect is mitigated by the dividends received deduction and the maximum tax rate for dividends of 20%.
- As of Tax Year 2018, Tax Rate reduced to 21% due to U.S. Tax Reform. Affects analysis of making the election going forward.
- No FET
- No withholding tax

953(D) & 831(B) ELECTIONS

831(b) Election

- Available to captives that have made the §953(d) election
- Premiums must be no greater than $2,300,000 (for 2018)
- If election is made, it is effective for the year made and all subsequent years when the requirements are met.
- Company will be taxed on net investment income only
- Company may lose the benefit of net operating losses
- Capital losses will still carry forward for 5 years
- Recent Focus of the IRS
- “Diversity” tests

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U.S. TAX REPORTING REQUIREMENTS

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U.S. TAX REPORTING REQUIREMENTS

Common U.S. Tax Forms Summary

- Form 5471 – shareholders & directors of non-Section 953(d) electing captive
- Form 926 – capital contributions to a non-Section 953(d) electing captive
- Form 8938 – reporting of foreign assets of captive
- Form 8975 – country by country reporting for non-Section 953(d) electing captive
- Form 1120-PC – corporate income tax return for a Section 953(d) electing captive
- Form 1120-F - protective corporate income tax return for non-Section 953(d) electing captive
- Form 720 - quarterly filed federal excise tax return for premiums paid to non-Section 953(d) electing captive
- Form W-9 or W-8BEN-E (“FATCA”) – U.S. federal tax status of captive and its owners
- FinCEN Form 114 (“FBAR”) – foreign bank account report required regardless of captive tax elections

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RECENT DEVELOPMENTS

RECENT DEVELOPMENTS

Cases/Highlights

- *Rent-A-Center*
  - 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)
- *Securitas*
  - 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

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RECENT DEVELOPMENTS

Cases/Highlights

- *R.V.I. Guaranty*
  - "Residual value insurance" policies provided protection against the depreciation risk of an asset
  - "Investment risk" vs. "insurance risk" question
  - Court held in favor of the taxpayer because:
    - Sufficient fortuity in whether a risk of loss could occur
    - Similar types of coverage have been approved by state regulators, financial statement auditors and the insurance industry
    - Coverage similar to mortgage guaranty insurance which also qualifies as insurance for tax purposes

- *Avrahami / Reserve Mechanical*
  - Courts concluded that arrangements were not insurance by focusing on risk distribution and commonly accepted notions of insurance
  - Insufficient numbers of losses paid, insured parties and actuarial "exposure units"
  - Circular cash flows, unreasonable premiums/weak actuarial analyses, poor governance practices/investment decisions
  - Deference to regulators regarding adequate capitalization
  - Insufficient documentation supporting risk transfer/pooling, allocation of risks to insureds, and alternative tax arguments
  - Non-insurance premiums can be treated as another type of income and subjected to U.S. withholding taxes

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RECENT DEVELOPMENTS

IRS

- Continue to ignore RAC and Securitas in public guidance
- Larger group of reviewers has been established to assess Section 953(d) elections
  - No longer a "rubber stamp"
  - Generally will evaluate whether estimated income taxes have been paid
- Recent Priority Guidance plan does not include captive insurance as an agenda item
- Referenced Section 831(b) "micro" captives on its "Dirty Dozen" list of tax abusive transactions/tax shelters
- Formalized its skeptical view of many micro captives with the release of IRS Notice 2016-66
  - Scrutinizing promoters involved in large-scale implementation of such arrangements
  - Looking for captives charging artificially high premiums for "non-traditional" risks
  - Captives with minimal losses could be vulnerable to challenges

RECENT DEVELOPMENTS

Cayman Country-by-Country Reporting (“CbCR”)

- **CbCR was gazetted in the Cayman Islands on December 15, 2017**
- **It applies to multinational entity groups (MNE Groups):**
  - that are required to prepare consolidated financial statements
  - that earn more than USD 850 million in total consolidated group revenue
  - and that have two or more entities tax residents in different jurisdictions
- **The first reporting was due May 31, 2018 for the December 31, 2016 FYE (a catch-up year).**
- **A Cayman captive subsidiary of a U.S. parent company may have a “one-off” notification filing requirement (through the Cayman electronic filing “portal”)**
- **Differing views regarding whether this filing requirement could apply to a Section 953(d) electing company**

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STATE TAX

STATE TAX CONSIDERATIONS

- U.S. domiciled captives are typically subject to state tax on their gross receipts / premiums received that are sourced to that state
- 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)
- These taxes are often applied at the insured level (similar to a sales tax) in lieu of taxing the captive's income at the captive level
- 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
- Even states without a self-procurement tax should be monitored in light of the recent *Microsoft* matter in which the taxpayer agreed to pay premium taxes to the state of Washington for transactions involving a non-resident captive

Mike Domanski
mdomanski@email.com

T.C. Leshikar
tc.leshikar@pwc.com

www.caymancaptive.ky

THANK YOU

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