

FOREIGN PROTECTED CELL INSURANCE COMPANIES: A COMPARATIVE ANALYSIS



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Last year, the National Treasury released a media statement entitled 'Ongoing Investigation – Offshore Captives and Protected Cell Companies'; the statement was released along with the Taxation Laws Amendment Bills, 2010. Its purpose was to highlight the ongoing review of tax issues relating to offshore captives and protected cell companies. However, it was eventually decided that these issues should be investigated further rather than introduced for inclusion within the Taxation Laws Amendment Bills, 2010.

Also in 2010, the Internal Revenue Service (IRS), Department of the Treasury of the United States issued a notice of proposed rulemaking regarding, in part, the classification for US Federal tax

purposes of a foreign series or cell that conducts an insurance business. The proposed regulations provide that, whether or not a foreign series or cell that conducts an insurance business is a juridical person for local law purposes, for US Federal tax purposes, it is treated as an entity formed under local law. The proposed regulations would affect foreign series or cells that conduct insurance businesses and their owners.

What is a protected cell insurance company?

In general, statutes in a few jurisdictions provide for chartering of a legal entity (or the establishment of cells) under a structure commonly known as a protected cell company, segregated account

company or segregated portfolio company (cell company). It is usually the case that a cell company may establish multiple accounts, or cells, each of which has its own name and is identified with a specific participant, but generally is not treated under local law as a legal entity distinct from the cell company.

A cell company generally offers limited liability for each cell within the company. Stated differently, each cell is a stand-alone company only for limited liability purposes, meaning that creditors seeking funds from a cell cannot look to the rest of the cell company or other cells for assets. Ownership structures of cell companies vary but typically the arrangement will consist of a cell company



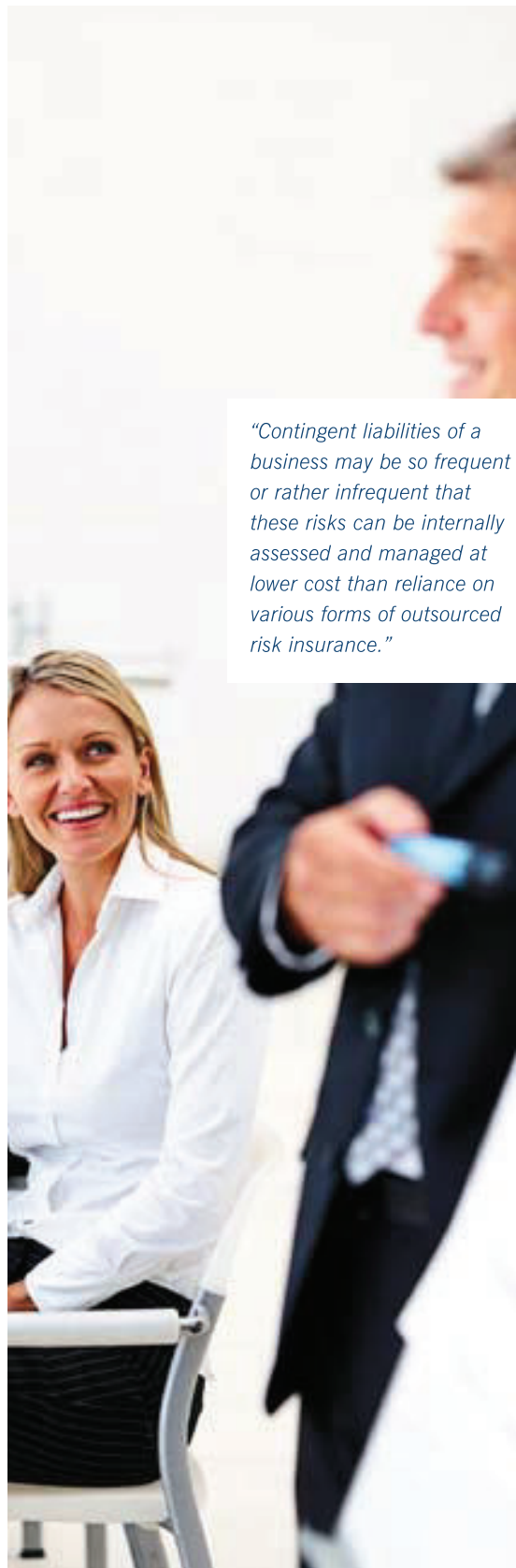
reserved for the shareholders with ownership held through ordinary shares. Other cells represent other ownership interests with ownership of each cell held through a separate class of shares. Variations in the structure of offshore cell entities depend on jurisdictional statutes. In addition, some jurisdictions also segregate the liquidation of the cells, and other jurisdictions even segregate tax treatment and consequences.

It may help to associate the concept thinking of the arrangement as if the cell company is acting as the parent company and the cell a subsidiary. Similar to affiliated separate legal entities, assets of each cell are statutorily protected from the creditors of any other cell and from the creditors

of the cell company. Nevertheless a difference arises, since these cells are generally not treated as separate entities for purposes under local law, they do not provide for separate stockholders, members, partnership or other ownership rights.

More than 15 jurisdictions currently offer protected cell insurance legislation. The benefits of using a protected cell are easily summarised. First, since the cells are not independent legal entities, the cost to form and administer the insurance operation is less than it would otherwise cost to form independent insurance entities. Second, the assets of each cell are statutorily protected from the creditors of other cells, and from that of the cell company, providing for the same legal asset

protection with the administrative cost saving element as discussed above. Notwithstanding the status as one legal entity including the cell company and its cell(s), most jurisdictions provide for similar rights and responsibilities with regard to insurance underwriting with slightly modified provisions which are beneficial to cell account holders. In sum, cells allow the insured to limit costs associated with the service premium attendant (otherwise known as a third party administrator) typical with outsourced insurance without incurring the level of cumbersome regulatory costs associated with a controlled captive subsidiary (e.g. the annual license fee, upfront registration with the regulatory agencies as well as capital investment.)



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A captive insurance company is generally defined as a company that insures the risk of the premium payor which provides for retention of underwriting profits by such premium payor. These insurance companies may be arranged as traditional corporate entities, and as was discussed above, as cell companies and cells. The National Treasury notes that captive subsidiaries can be a legitimate method of managing risk. Contingent liabilities of a business may be so frequent or rather infrequent that these risks can be internally assessed and managed at lower cost than reliance on various forms of outsourced risk insurance.

South Africa’s stance

South Africa states that it generally has two concerns with international captive insurance and insurance cells. The first concern relates to the over-funding of offshore captives in order to artificially generate deductions. The second related concern is the growing existence of offshore protected cell companies.

The National Treasury admits, despite their commercial uses, captive subsidiaries (especially offshore captive subsidiaries) may be used to undermine the national tax base. The income tax system does not generally permit deductions for reserves against future risks. If the captive subsidiary generally pays out claims equal to (and within a short time after) premiums received, little risk exists to the tax base. The tax base is at risk only once payouts are less than premiums received or the time delay between the two events becomes too far apart.

A related concern also exists that the over-funding of captives may represent an attempt to obtain deductions for amounts that are otherwise viewed as non-deductible investments.

In terms of tax avoidance, the main concern of the National Treasury is the use of offshore captive insurers. Offshore captive insurers may be taxed at low rates or in some cases even go untaxed when receiving premiums, even if the insurer fails to make corresponding payouts after a long period. Some instances may even occur where because of creative use of multiple structures and/or jurisdictions, these insurers may be able to distribute the excess premiums back to the insured free of tax in addition to the deduction that was taken when the premium

was first paid. Although current tax rules relating to controlled foreign companies is designed to curtail this practice, the controlled foreign company tax rules do not apply to all offshore captives under indirect South African control (a precondition for applying the controlled foreign company rules.)

In particular, the National Treasury contends that most jurisdictions offering cell legislation can also be viewed as tax havens or low-tax/no tax jurisdictions. The nature of the cell which the National Treasury is concerned about is such that cells could under certain circumstances evade offshore tax avoidance legislation, such as the rules relating to controlled foreign companies. It is these tax avoidance uses that are of concern to the local tax system.

The National Treasury continues to have the following tax proposals remain under consideration:

(i) Tightened controlled foreign company legislation: the ownership criteria for controlled foreign companies could be tightened. Under this scenario, each cell in an offshore protected cell company would be measured as a deemed separate company. In addition, the effective management test could be measured cell-by-cell rather than company-by-company. The goal of these changes would be to neutralise the tax benefits of an offshore cell vis-à-vis an onshore cell.

(ii) Taxable premium calculations: the current tax rules are designed to ensure that short-term insurance premiums should generally be taxable in the hands of the short-term insurer unless claims relate to the year of receipt. However, a growing number of exceptions appear to be emerging in this regard. Co-ordination will also be required with new insurance regulatory criteria so that over-conservative principles are not utilised to undermine the tax base.

(iii) Dividend recoupments: tax avoidance cycle schemes appear to exist involving the over-funding of captive insurers. Under this practice, the captive is over-funded to reduce the tax base of the insured; the overfunded insurer then repatriates the funds back to the insured via tax-free dividends. One option would be to create a deemed recoupment for dividends recycled in this manner.

(iv) Limiting deductible payments: deductible premiums may have to be limited in the case of captive insurance relationships to prevent overfunding. In addition, the timing rules for insurance premium deductions may have to be reviewed so that insurance premium deductions more closely match the income of captive short-term insurers.

The United States' position

By issuing the proposed guidance in 2010, the United States Treasury attempts to remedy the situation that under current US law that there is little specific statutory guidance regarding whether for US Federal tax purposes a cell is treated as an entity separate from other cells or the cell company, as the case may be, or whether the company and all of its series (or cells) should be treated as a single entity.

The proposed regulations provide that, for Federal tax purposes, ownership of interests in a cell and of the assets associated with a cell are determined under general tax principles. The rule provided in the proposed regulations is designed to provide greater certainty to both US taxpayers and the IRS regarding the tax status of foreign cells that conduct insurance businesses. In effect, taxpayers who establish cells are placed in the same position as persons who file necessary documentation for a separate legal entity. The IRS and the Treasury Department believe that a rule generally treating foreign insurance cells as separate legal entities would be consistent with taxpayers' current ability to create similar structures using multiple legal entities that can elect their Federal tax classification pursuant to Federal Regulations.

The IRS and the Treasury Department further contend that they believe a cell should be classified as separate legal entities based on the characteristics granted to them under the various statutes. Even further, IRS and the Treasury Department believe that a cell should be treated

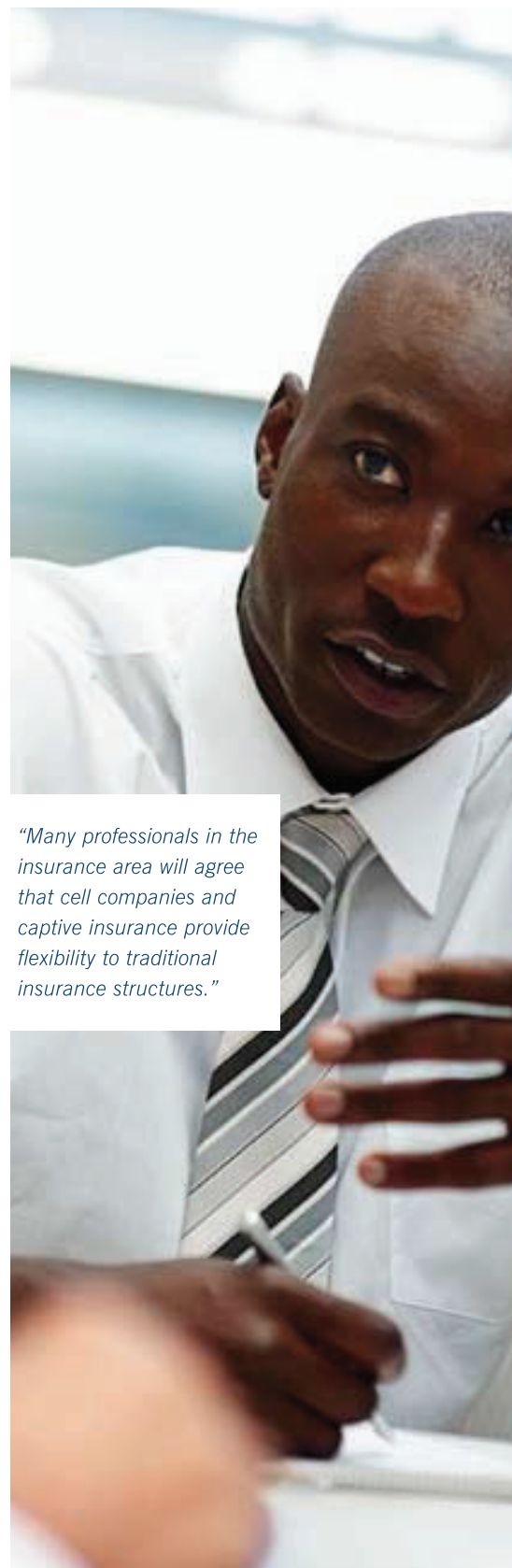
as a separate legal entity even if its business purpose, investment objective or ownership overlaps with that of other cell or the cell company itself. Generally, this position is contrary to that taken by the South African Government.

Under the proposed US regulations, a cell conducting an insurance business, which is organized or established under the laws of a foreign jurisdiction, is treated as an insurance business if the arrangements and other activities of the cell, if conducted by a domestic company, would result in its being classified as an insurance company under US law. Thus, a foreign cell would be treated as an entity if more than half of the series' business is the issuing or reinsuring of insurance or annuity contracts.

Almost half the US states provide for some form of captive insurance legislation. What's more, since the IRS is likely to treat foreign cell companies and cells in the manner described above, it is likely that this form of insurance will continue to become more commonplace domestically.

Conclusion

The two dissimilar positions illustrated here attempt to uncover the varying treatment of offshore insurance arrangements generally. The South African Government appears anxious to curtail overuse and even abuse of offshore captive and cell insurance companies. On the other hand, that the US is currently providing proposed guidance can be taken as a sign indicating the potential future general acceptance of these arrangements. Many professionals in the insurance area will agree that cell companies and captive insurance provide flexibility to traditional insurance structures. Thus, progressive jurisdictions in the area of insurance company law regarding cell legislation may benefit from their willingness to provide such flexibility within the captive cell company marketplace.



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¹ See National Treasury, 'Ongoing Investigation – Offshore Captives and Protected Cell Companies'. http://www.treasury.gov.za/comm_media/press/2010/2010051002.pdf. 10 May 2010. Last Accessed 9 March 2011.

² See 75 Federal Register 55699-01. 'Series LLCs and Cell Companies'. Tuesday, 14 September 2010.

³ See, for example, The Companies (Guernsey) Law, 2008 Part XXVII (Protected Cell Companies), Part XXVIII (Incorporated Cell Companies); The Companies (Jersey) Law, 1991, Part 18D; Companies Law, Part XIV (2009 Revision) (Cayman Isl.) (Segregated Portfolio Companies); and Segregated Accounts Companies Act (2000) (Bermuda).

⁴ See Captivereview.com. Cell Company Guide. <http://www.captivereview.com/data-centre/cell-company-guide/>. Last Accessed 9 March 2010.

⁵ National Treasury, 'Ongoing Investigation – Offshore Captives and Protected Cell Companies'.

⁶ 26 U.S.C. §816.