

CAPTIVE INSURANCE: Primer and Federal Tax Overview

November 2009

KRW

KERR, RUSSELL AND WEBER, PLC
ATTORNEYS AND COUNSELORS

Overview

1. Types of Captives
2. Captive Insurance Domiciles: Foreign versus Domestic Jurisdiction Considerations
3. Professionals Required for Captive Formation and Operations
4. Federal Tax Considerations
 - IRS Definition of Insurance
 - Foreign Tax Considerations
5. Current Legislation

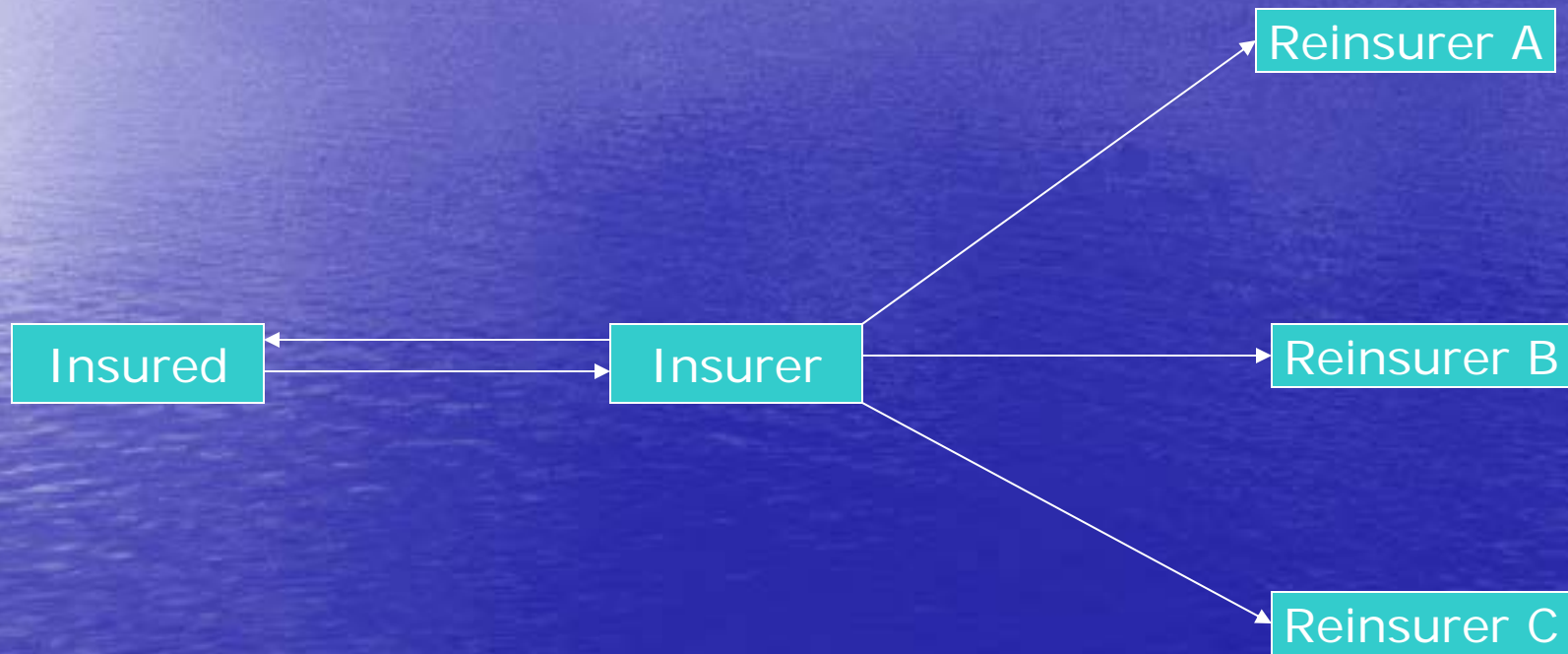
Types of Captives

- Pure/Single Parent Captives
- Association Captives
- Group Captives
- Risk Retention Group (RRGs)
- Cell Captives
- 831(b) – Small Captives

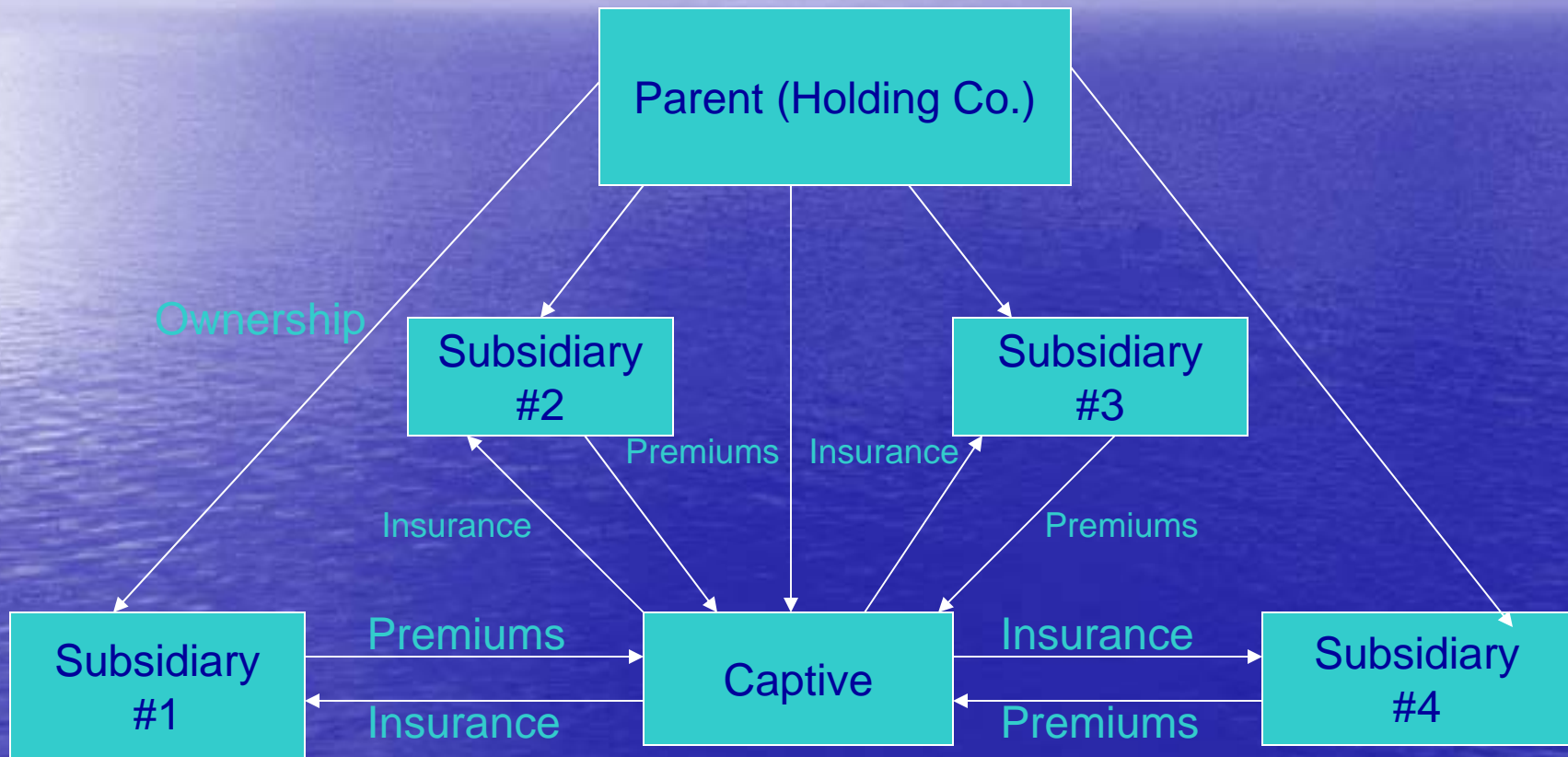
Fronted vs. Direct Write

- Fronted Program (with licensed stateside carrier partner)
- Direct Write Program (no carrier partner)
 - Customize policy to your business/risks
 - Insured's Duty to defend claims; Insurer's Duty to Indemnify
 - Add other types of coverage (wrongful termination; business interruption; regulatory violations)

Traditional Insurance v. Single Parent Captive

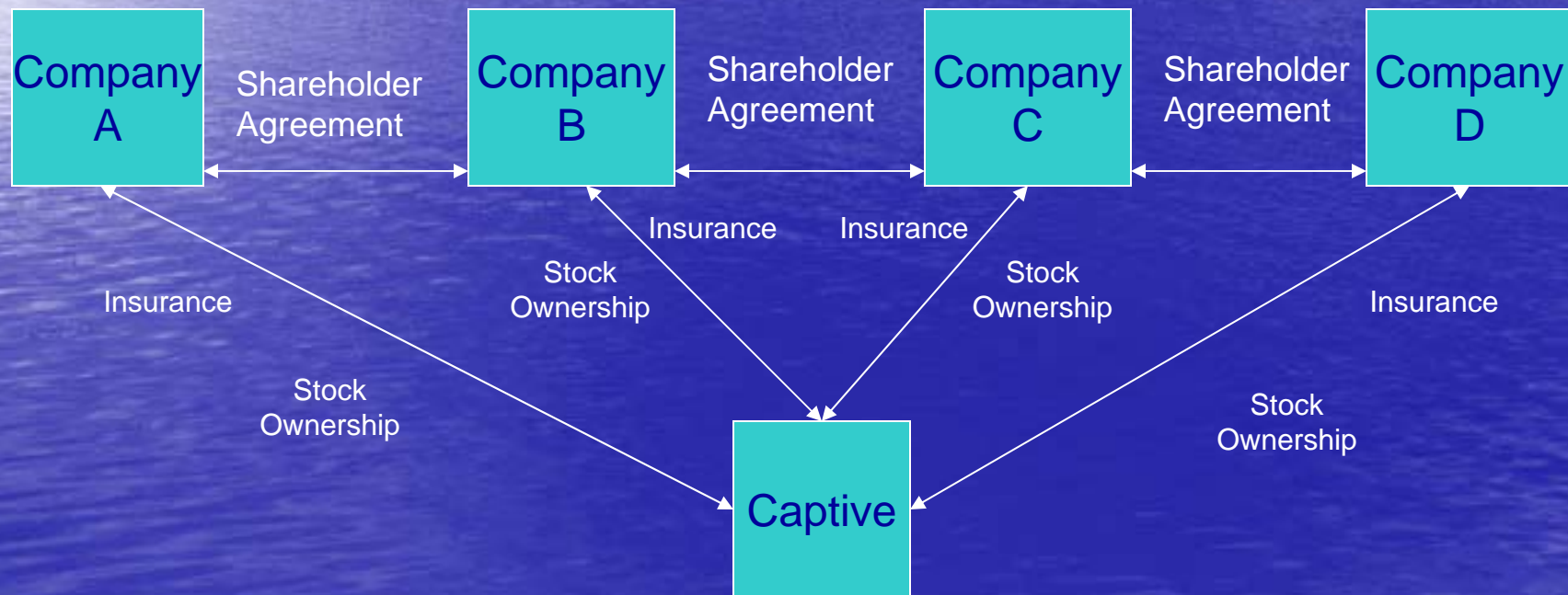


Single Parent Captive (Serving Affiliates)



Group Captive

- Several owners form an insurance company to insure/reinsure risks of its owners (or affiliates)



Rent-A-Captive

- An insurer or reinsurer that rents its capital, surplus and legal capacity to client users
- The sponsor, not the policyholder, controls the rent-a-captive and usually provides administrative services, reinsurance, and/or an admitted fronting insurer
- The Policyholder does not own the captive, but benefits from a risk funding component of the captive (cell or account) set up for the policyholder

Small Captives

- Sec. 831(b)
 - No taxation of premiums received
 - Limitation of \$1.2 million in annual premiums
 - Taxed solely on investment income
 - Files Form 1120-PC
 - Estate Planning Benefits

Captive Insurance Domiciles

Domestic Jurisdictions

1. Vermont: 567 (11.4%)
2. South Carolina: 158 (3.2%)
3. Arizona: 108 (2.2%)

Foreign Jurisdictions

1. Bermuda: 958 (19.3%)
2. Cayman: 765 (15.4%)
3. BVI: 409 (8.2%)

Michigan: On March 13, 2008, the Michigan Captive Insurance Act signed into law (Public Act 29 of 2008)

- Authorized the formation and licensing of captive insurance companies in Michigan

Domicile Decisions: Comparison of Tax Rates and Capital Requirements

	Vermont	Arizona	Bermuda	Cayman
Premium Tax Rate on Direct Business	0.380% on first \$20 million 0.285% on next \$20 million 0.190% on next \$20 million 0.072% thereafter	No premium taxes, direct or assumed	No local premium tax is imposed *FET	No local premium tax is imposed *FET
Premium Tax Rate on Reinsurance	0.214% on first \$20 million 0.143% on next \$20 million 0.048% on next \$20 million 0.024% thereafter	No premium taxes, direct or assumed	No local premium tax is imposed *FET	No local premium tax is imposed *FET
Annual Minimum Tax	\$7,500	Zero state income tax on profits is earned by the captive	Bermuda has no income, profit or capital gains tax.	No income tax plus 20-year guaranteed tax-exempt status
Minimum Capital & Surplus	\$250,000	\$250,000	\$120,000	\$120,000

Required Professionals

- Actuaries
- Tax Professionals
- Risk Managers
- Insurance Accountants
- Lawyers (Corporate and Regulatory)
- Domicile Representatives
- Independent CPA/Auditor

Federal Taxation of Insurance

- Definition of Insurance
 - Risk Shifting
 - Risk Distribution
- Safe-Harbors
- Foreign Taxation Considerations

IRS Definition of Insurance

- A deduction is allowed for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business – Section 162
- Included in business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business – Section 1.162-1(a)
- The IRS and courts require both Risk Shifting and Risk Distribution
 - Risk Shifting involves the transferring of economic risk to another party
 - Risk Distribution entails sufficiently large number of risks are pooled

Definition of Insurance (cont.)

- Neither the Code nor the regulations define the terms “insurance” or “insurance contract”
- Insurance for federal income tax purposes requires both risk shifting and risk distribution for an arrangement to constitute insurance
 - *Helvering v LeGierse*, 312 US 531 (1941)
- “[C]overage provided by an insurance contract should fall within the ‘commonly accepted sense’ of insurance”
 - TAM 200827006
- Facts and circumstances test includes not only the terms of the arrangement, but also the entire course of conduct of the parties
 - Rev. Rul. 2005-40

Risk Shifting

- Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment
- IRS will look to facts and circumstances
 - Parental Guarantees

Risk Distribution

- Pooling of Premiums

- Risk distribution entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks
- When a company “insures” unrelated risks, the arrangement constitutes insurance if a significant percentage of unrelated risks exists
 - See, *Ocean Drilling & Exploration Co*, 988 F2d 1135, 1152-53 (Fed Cir 1993); *Sears, Roebuck & Co*, 96 T.C. 61, 100-02; *Harper Group v Comr*, 96 T.C. 45, 58 (1991)
- Brother-sister subsidiary corporations (i.e., subsidiary corporations of the same parent) may establish an arrangement and qualify as insurance for federal income tax purposes even if there are no insured policy-holders outside the affiliated group so long as risk shifting and risk distribution are present
 - Rev. Rul. 2008-8 citing *Humana, Inc*, 881 F.2d 247 (6th Cir 1989); *Kidde Industries v US*, 40 Fed Cl (1997); Rev. Rul. 2002-89
- A parent corporation with a direct arrangement with its own insurance subsidiary will still require sufficient risk pooling
 - See *Humana, Inc*, at 257 (6th Cir 1989)

Risk Distribution

- The risk transferred must be risk of economic loss
 - *Allied Fidelity Corp v Comr*, 572 F2d 1190, 1193 (7th Cir), cert. denied, 439 US 835 (1978)
- The risk must contemplate the fortuitous occurrence of a stated contingency and must not be merely an investment or business risk
 - *Comr v Treganowan*, 183 F2d 288, 290-91 (2d Cir), cert. denied, 340 US 853 (1950); *LeGierse*, at 542; Rev. Rul. 89-96
- TAM 200827006 – concluding that a policy covering short-term, customary product warranties cannot constitute an insurance contract
 - Risks are controlled by manufacturer
 - Lacked necessary fortuity

Parent Captives

- Harper Group Rule - *The Harper Group*, 979 F2d 1341 (9th Cir 1992)
 - Courts have not established a bright line percentage test
 - *Harper Group* represents the edge
 - Tax Court found an insurance agreement with the least amount of unrelated risk (29%)
 - The transaction, in *Harper Group*, involved a “relatively large number of unrelated insureds” which the court used as a basis for finding significant risk distribution
- Other cases recognize that risk distribution involves not only the portion of unrelated risks assumed but also a large number of insureds
 - See, e.g., *HCA v Comr*, T.C. Memo 1997-482 (1997) (taxpayer operated an average of 160 hospitals); PLR 200724036 (only five risk exposure units in 2004 and seven in 2005)

Economic Family Theory

- IRS disallowed deductions in parent-child and brother-sister captive structures
 - Rev. Rul. 77-316
- Early success by IRS, then courts rejected theory
- IRS backed off in Rev. Rul. 2001-31 (Need sufficient third-party risk)

The Safe-Harbor Revenue Rulings

- 2002-89: Two situations in which arrangements between a domestic P parent corporation and its wholly owned insurance subsidiary, S, for insurance:
 - Situation 1: P constitute 90% of S 's total premiums earned during the taxable year on both a gross and net basis. The liability coverage S provides to P accounts for 90% of the total risks borne by S
 - Situation 2: P constitutes less than 50% of S's total premiums earned during the taxable year on both a gross and net basis. The liability coverage S provides to P accounts for less than 50% of the total risks borne by S
- 2002-90: The IRS has in one recent field service advice (FSA 200202002) indicated that the *Humana* line of cases applies only where there are multiple affiliated subsidiaries involved. That position is adopted in Rev. Rul. 2002-90 establishing a safe harbor at 12

The Safe-Harbor Revenue Rulings

- 2002-91: Group captive arrangement
 - No member owns more than **15%** and no member has more than **15%** of the vote on any corporate governance issue
 - Further, no member's individual risk that is insured exceeds **15%** of the total risk insured
- 2005-40: Single Member LLC's are Disregarded Entities and therefore do not count as separate insured brother/sister entities

CFC Rule Changes for Insurance

§ 951(a)(1) imposes current U.S. tax on the “pro rata share” of a “United States shareholder” in various types of income of a “controlled foreign corporation (CFC)”

– 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

- CFC Insurance Rule: If, on any day during its tax year, U.S. Shareholders own more than 25% of the combined voting power of all classes of stock, or more than 25% of the total value of the foreign corporation

Indirect Ownership and Attribution

- Control includes indirect ownership and attribution of stock ownership → a person is treated as owning shares of stock held indirectly through entities or owned by related persons. IRC § 958
- This will include family members and entities of lower tiers
 - Subpart F incorporates constructive ownership rules based on §318 with certain modifications
- The constructive ownership rules apply for purposes of, among other things, determining whether:
 - A U.S. person is a U.S. Shareholder
 - A foreign corporation is a CFC
 - The stock of a domestic corporation is owned by a U.S. Shareholder of a CFC for purposes of §956(c)(2); and
 - A corporation or other person is related to the CFC

NON-CONTROLLED FOREIGN CORPORATION

- Foreign captive as a non-Controlled Foreign Corporation (NCFC)
 - Accomplished by having non-U.S. shareholders
 - An alternative would be to have some foreign ownership of the captive, although constructive ownership rules apply if a foreign subsidiary own the captive
- The advantage of a NCFC is that earnings and profits would not be subject to U.S. tax until repatriated
- NCFC status also accomplished by § 953(d) election

Related Party Insurance Income (RPII)

- Section 953: RPII income is defined by the tax code as:
 - "any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is a U.S. Shareholder in a foreign corporation or related person to such a shareholder"
- There are two *de minimus* exceptions to the RPII rules:
 - If RPII income in a particular year is less than 20% of the company's total insurance income then RPII rules will not apply for that year; and
 - If all RPII income is generated by less than 20% of the company's shareholders the RPII rules would not apply
- The effect of these rules is to make group captives subject to U.S. taxation or cause such a dilution of ownership and control that a NCFC captive is no longer an attractive alternative

Cascading FET

- FET (Federal Excise Tax) imposes taxes pursuant to § 4371 as a cascading tax
 - Industry position: Applied only on the premiums transferred from the US to a foreign insurer
 - IRS position: Domestic insurers pay an excise tax each and every time a premium is ceded to a foreign (re)insurer
 - 4% for insurance premiums paid (1% for reinsurance premiums)
- Rev. Rul. 2008-15: IRS wins

Election to be taxed as US entity – The 953(d) election

- Avoid the 4% FET on premiums paid to offshore insurance companies (1% for reinsurance)
- Must meet five requirements:
 1. Must be a CFC under § 957(a) (modified by § 953(d)(1)(A))
 2. Insurance Company qualification under the Code
 3. Any additional requirements under the Regs (none at this time)
 4. An election must be filed by the due date of the first tax return
 5. Waive all treaty rights between US and the foreign domicile

Current Legislation and Initiatives

- Stop Tax Haven Abuse Act
- HR. 3933 and S. 1934
- HR. 3424
- FBAR
- Rev. Rul. 2009-26



Questions and Comments