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PERSPECTIVES

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**EFFECTS OF PROPOSED IRS REGULATION
ON TAX BENEFITS OF CAPTIVES**

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On September 28, 2007, new Proposed Regulations were published under § 1.1502-13(e) (the "Proposed Reg.") which, if made final, would have a rather dramatic effect on reserve deductions taken with respect to premium payments made to captive insurance companies.

Background

In 1977, the Internal Revenue Service (IRS) promulgated Rev. Rul. 77-316, 1977-2 C.B. 53, in

which the IRS advanced the so-called "economic family theory" ("the EFT"). In general, based on the EFT, the IRS took the position that in the case of an affiliate insured with an insurer under common ownership, no deduction would be allowed for premium paid by the affiliate to the insurer because there had been no transfer of risk outside the affiliated group. As a further consequence, because the premium would not

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Editor's Note: This month's *Perspectives* offers a discussion on recently proposed IRS regulations that could have a significant impact on owners of captive insurance companies. Under current regulations, the IRS allows an exemption from the rules for matching transactions between a captive insurance company and its commonly owned group members. Premiums paid into the captive can be taken as a deductible expense by the group members. From the captive's standpoint, premium is recognized as income, and loss reserves are deductible for tax purposes. The proposed regulations essentially remove the exemption for intercompany insurance transactions. A captive would not be able to deduct reserves for losses until the losses are actually paid.

The authors, P. Bruce Wright and M. Kristan Rizzolo of Dewey & LeBoeuf LLP, present the technical aspects of this departure from the 1995 regulations for consolidated returns.

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be considered as such, the insurer would not be considered to receive an insurance premium payment, and as such would not be treated as an insurance company for federal income tax purposes. Under this approach, losses would only be allowed under Section 165 of the Internal Revenue Code when they were incurred.

Thus, the net current benefit realized in the corporate group, the deduction for a reserve by the reinsurer, was not allowed. It should be noted that the reserve (which is discounted in calculating taxable income, see IRC § 846) is the net benefit because within the group the payor would otherwise take a deduction for premium under IRC § 162 and the insurer would include that amount in income under IRC § 831. Thus,

within the corporate group, the tax benefit obtained is the amount of the discounted reserve.

Although the IRS had some early success in denying premium deductions under these cases, see, e.g., *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987), *aff'g* 84 T.C. 948 (1985), the court never seemed to accept the EFT. Further, as cases in this area were litigated, courts adopted several theories based upon which taxpayers were permitted to take deductions.

The Unrelated Business Cases

Several cases were decided that indicated that if the captive accepted sufficient risk unrelated to the corporate group, the premium paid with regard to related risk would retain its character as insurance premium, see e.g., *Harper Group & Includible Subsidiaries v. Commissioner*, 979 F.2d 1341 (9th Cir. 1992), *aff'g* 96 T.C. 45 (1991); *Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993), *aff'g* 24 Cl. Ct. 731 (1991).

The Brother-Sister Cases

Further, courts concluded that premium paid by an affiliate of, as opposed to the parent of, a captive would retain its character and be treated as an insurance premium. See, e.g., *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), *aff'g in part and rev'g in part* 88 T.C. (1987); *Kidde Indus., Inc. v. United States*, 40 Fed. Cl. 42 (1997).

In 2002, the IRS published what essentially were safe harbor guidelines recognizing the *unrelated business cases* and the *brother-sister cases*. The revenue rulings set the factual parameters within which the IRS apparently would follow these cases.

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Published by
International Risk Management Institute, Inc.[®]
12222 Merit Drive, Suite 1450
Dallas, Texas 75251-2276
Phone (972) 960-7693 • Fax (972) 371-5120
www.IRMI.com

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The Proposed Reg., in essence, reverses the results of those cases with respect to related risks written by a captive which is part of a consolidated group. The captive would be denied reserve deductions for reserves attributable to risks of other members of the consolidated group. Instead, the normal timing rules for deductions under IRC § 165, taking into account the economic performance rules of IRC § 461(h), would apply. This is a significant departure from the consolidated return regulations adopted in 1995, which respected direct insurance transactions between captives and members of their consolidated groups. That said, several points should be analyzed.

1. For federal tax purposes, a captive will be considered part of a consolidated group if (a) it is domestic, *i.e.*, U.S. company, and (b) 80 percent of the vote and value of its outstanding shares are owned by the group. Thus, the Proposed Reg. will apply to a captive only if it is formed in domestic domiciles or is treated as a U.S. taxpayer because it has made an election under IRC § 953(d) to be treated as such. It will not apply to non-electing foreign captives or to captives with respect to which U.S. members of the consolidated group do not meet the vote and value requirements. Further, if the captive were owned by a partnership or other entity which would not be included in the consolidated group, the Proposed Reg. would not apply.
2. The Proposed Reg. applies what may be considered to be a "mechanical rule" to eliminate the reserve deduction attributable to affiliated risks; it does *not* recharacterize the income received by the captive as other than an insurance premium. Thus, in testing whether the captive is an insurer under IRC § 831(b), payments otherwise treated as premium, *e.g.*, pre-

mium derived from brother-sister companies as opposed to a parent, would retain their character. In addition, the captive would be able to establish and deduct reserves for risks unrelated to the consolidated group. Presumably, in determining whether risk is or is not from the consolidated group, one would look to the underlying risk. Thus, if a member of the consolidated group placed a policy with an unrelated licensed insurer and the risk was reinsured with the captive, the risk would be treated as group risk, and the Proposed Reg. would only allow a deduction when allowed under IRC § 165 taking into account the economic performance rules of IRC § 461(h), which in general require payment. Preamble to Consolidated Returns; Intercompany Obligations, F.R. Col. 72, No. 188 (September 28, 2007). However, if risk from outside the consolidated group were written by an affiliated insurer and ceded to the captive, it presumably would be treated as derived from outside the group and a reserve would be able to be established.

3. The Proposed Reg. also has a *de minimis* rule (which would not be applicable to most captives) which provides that if less than 5 percent of the risk assumed by the captive is from outside the consolidated group, the Proposed Reg. will not apply.
4. The consolidated return regulations incorporate an anti-abuse provision which allows the IRS to make adjustments to carry out the purposes of the provisions if a transaction is "engaged in or structured with a principal intention to avoid the purposes of the intercompany transaction" rules. The Preamble to the Proposed Reg. specifically states that the IRS may use the anti-abuse provision to prevent avoidance of the Proposed Reg. rules through use of a fronting company.

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In a recent Chief Counsel Advice, CCA 200729035 (April 11, 2007) (CCA), the IRS applied the anti-abuse rule to conclude that a non-consolidated entity, a cooperative, should be treated as a consolidated entity for purposes of applying the intercompany transaction rules. The cooperative would be prevented (under the CCA) from taking advantage of special tax accounting rules available to cooperatives with respect to members of the consolidated group in which it would be included. The IRS determined that structuring the cooperative as a nonconsolidated entity had no business purpose, but instead was done solely to prevent the application of the intercompany transaction rules. This, however, seems to be the only authority in which the IRS has treated a nonconsolidated entity as consolidated where the nonconsolidation was nontransitory. Thus, in the event the Proposed Reg. becomes final, restructuring may have to be accomplished with some care.

Conclusion

The IRS solicited comments on the proposed regulations through December 27, 2007. At the moment, it is unclear if and when new regulations will be finalized. The Vermont Captive Insurance Association and the Captive Insurance Companies Association formed a coalition to coordinate an industry response, including comments filed with the IRS and testimony at an IRS hearing, with a goal of convincing the IRS and the Department of Treasury that the Proposed regulations should be withdrawn.

If the captive industry is unsuccessful in its efforts and the Proposed regulations become final, individual taxpayers will need to consider how best to minimize the effects. In this regard, companies will want to consider different options for deconsolidating their captives in light of their particular facts and in light of the anti-abuse rule in the consolidated return regulations.

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