IRS DOUBLE CROSSES CAPTIVE COMMUNITY

Standfirst: John Weitzel explains the implications of the latest IRS betrayal.

In 2001, the Internal Revenue Service (IRS) issued Revenue Ruling 2001-31, which indicated that the Service was no longer going to invoke the economic family theory in those cases involving a taxpayer who self-insures through its wholly owned captive insurance subsidiary. The basic idea behind the Ruling is, that if a captive insurer provides insurance to an affiliate in the consolidated return, the transaction is currently accounted for on a "separate entity basis." The captive and the insured account for premiums and reserve changes as separate entities.

On September 11 of that same year, the terrorist attacks on America kick-started an extended hard market that lasted for some five years. Inspired by the favourable tax ruling, and given an extra boost by the hard market for traditional insurance products, many corporations migrated to the use of captive insurance. This phenomenal growth that ensued in the use of captive insurance has now led the US Treasury Department to reverse its earlier position.

With no warning, six years later, the IRS issued proposed regulations on 27 September 2007 that have the effect of eliminating the tax benefits provided by the existing tax regulations for certain related party insurance transactions. This complete turnaround in relation to new regulations will require certain captive insurers to wait until claims are paid before they can deduct the losses. Unpaid claims, whether reported or not, will not be tax deductible, even on a discounted basis. The end result of this move would be that the distinction between captive insurers with legitimate insurance arrangements and self-insured taxpayers will be eliminated.

As the captive sector struggles to understand this inexplicable act, the IRS has provided no theoretical justification for the proposed changes. They have simply acknowledged that the impact of separate entity treatment on overall income tax revenues has been greater than expected. In other words, the successful expansion of the use of captive insurance has provided the tax benefits to American taxpayers that were originally intended. However, the Treasury Department now needs those tax dollars to reduce its spending deficit.

The proposed regulations specifically address the treatment of transactions involving insurance between members of a consolidated group. They would only impact domestic corporations that file consolidated returns. In order for a captive to be included in a consolidated tax return, the domestic parent must own 80% or more of the captive. This includes foreign captives - which have elected to be treated as domestic for US tax purposes - that are a part of the same consolidated tax return group as the insured. For the most part, the proposed transactions will have no impact on association captives or risk retention groups

or captives whose ownership structure precludes consolidation with a single parent. It also would not affect small insurance companies taxed under Section 831(b) of the tax code.

As proposed by the IRS, separate entity treatment will no longer be permitted if a "significant amount" of the captive's business comes from affiliates in the consolidated tax return. What is "significant?" To achieve risk distribution for tax purposes, the safe harbour is 50% or more for third-party premiums. Most practitioners feel that 30% third-party activity will generally be recognised as risk distribution. Under the proposed regulations, even 95% "non-member" business is not enough. If 5% or more of the captive's premium comes from members of the consolidated tax return, the insurance or reinsurance transactions need to be reflected in the return on a "single entity basis". Essentially, the insured will be allowed to take a deduction for its premium expense, and this will be offset by the captive insurer recognising premium income. This is generally consistent with the current regulations. However, the captive insurer's loss reserves will no longer be tax deductible. Therein lies the rub. The captive insurer will essentially be treated the same as self-insurance.

Captives must not be lulled into thinking that they can simply qualify as insuring a nonmember of the consolidated group by merely interjecting a front in between the captive insurer and the affiliated insured. The IRS has threatened the use of "anti-avoidance" rules if they perceive reinsurance transactions as circumventing the single-entity rules.

South Carolina has taken a leadership role in resisting the proposed change. Within days of publication of the proposal in the National Register, Director of Insurance Scott Richardson sent a letter to his Congressman. He pointed out that proposed regulations might chase domestic captives to move offshore – a stark reversal of the favourable trends of the post-Enron era. Additionally, the South Carolina Captive Insurance Association has taken a public stance against the proposed regulations. South Carolina Captive Insurance Association's Government Advisory Committee is supporting the Self-Insurance Institute of America in its lobbying efforts targeted at Congress.

While the impact is limited to members of a consolidated group, the IRS is sending a clear message that they want more revenue from the captive insurance community. The Service has demonstrated a capricious approach to encouraging formation of captives in 2001. Now, six years on the IRS is indiscriminately penalising those that took their bait in 2001. They might next pursue similar penalties against those captives not affected by this current proposal. It will take a united front from interested parties to overcome this attack. The captive community has accomplished that in the past, and can do it again.