Captive Insurance

Still Confused After All These Years

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J. Walker Johnson, Partner
Steptoe & Johnson LLP, Washington, D.C

Dr. Irving H. Plotkin, PhD., Senior Managing Director
PricewaterhouseCoopers LLP, Boston

Richard Irvine, Managing Director & Tax Leader
PricewaterhouseCoopers LLP, Bermuda

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U.S. Taxation of Captive Insurance Companies

Richard Irvine, Managing Director & Tax Leader
PricewaterhouseCoopers LLP, Bermuda

Agenda

- US insurance tax accounting
- Onshore versus offshore captives
- Entity level taxation of captive insurance companies
- Shareholder level taxation of captive insurance companies
- Foreign Excise Tax (“FET”)

US Insurance Tax Accounting

Insurance - Understanding the U.S. Tax Benefits: *Captive versus Self Funding*

Why is "insurance" treatment important to a U.S. insured and a captive insurance company?

- FAS 5 Standard for accruing liabilities
  - "Estimable and Probable" Standard - FAS 5
- US Tax Standard for deducting accrued liabilities under IRC §461 - "Economic Performance Standard"
  - Liability must be "fixed and determinable"
  - Economic performance occurs within 8 ½ months (i.e., payment with respect to Tort and Workers Compensation liabilities) which restricts deductibility to 'cash method' for most accrued self insurance liabilities
- US Insurance Tax Accounting under Subchapter L
  - Insurance company may establish a deductible reserve which is 'fair and reasonable'
  - Insurance company ay earn revenues over period of obligation (e.g., Extended Service Contracts and multi year insurance contracts)

Insurance - Understanding the U.S. Tax Benefits: ***Captive versus Self Funding***

Why is "insurance" treatment important?

- In a consolidated group, the federal income tax benefit of a captive is not deductibility of premium, it is the ability to establish deductible loss reserves
  - Result - Achieve Tax/GAAP parity
  - Elimination of deferred tax asset
- Special Treatment for "Small Insurance Companies" (P&C only)
  - IRC §501(c) Tax Exempt
    - Gross Receipts < $600,000 on a controlled group basis
    - >50% Gross Receipts must be insurance premiums
  - IRC §831(b) Election
    - Taxed only on investment income
      - › Premium levels up to $1.2M
- Potential for estate and wealth transfer benefits

Insurance - Understanding the U.S. Tax Benefits: Definition of Insurance:

What is insurance for U.S. tax purposes?

- Neither the Internal Revenue Code nor the Treasury Regulations define the term “insurance” or “insurance contract.”
- Defined over time by the courts (1941 to present) which will be discussed in depth by Irv Plotkin.
- Have assumed for the balance of this discussion that the transactions are “insurance” and the captive meets the “primary and predominant” test (e.g., move than 50% of the business is the issuing of insurance or annuity contracts or reinsuring insurance or annuity contracts.

Onshore Versus Offshore Captives

Onshore Versus Offshore Captives
Advantages and disadvantages:

Onshore

- Approximately 39 domestic domiciles; as such, may be able to incorporate close by
- Reduction of potential self procurement taxes if captive domicile is "home state" for Dodd Frank purpose
- Not subject to Dual Consolidated Loss rules which could restrict the use of losses from the captive in a consolidated group
- Generally subject to domicile premium taxes
- Taxed as a corporation, as such, subject to two levels of taxation
- Absence of "reinsurance" market

Onshore Versus Offshore Captives
Advantages and disadvantages:

Offshore

- Of the ~5,000 captive insurance companies, ~70% are "offshore".
- Significant reinsurance market - Bermuda
- Potentially subject to a Federal Excise Tax ("FET") on premiums paid to a foreign insurer.
- Potential self procurement taxes as captive domicile is not the "home state" for Dodd Frank purposes.
- Subject to Dual Consolidated Loss rules which could restrict the use of losses from the captive in a consolidated group.
- Generally not subject to domicile premium taxes.
- Option for single level of income taxation.
- Potential for deferred taxation.
- Subject to FATCA.
- Offshore "taint".

Entity Level Taxation of Captive Insurance Companies

Entity Level Taxation:

Subject to tax by activities (offshore only)

- Engaged in a U.S. trade or business
- Permanent Establishment

Subject to tax by election (offshore only)

- IRC §953(d) Election
- IRC §953(c)(3)(C) Election

Subject to tax by incorporation (onshore only)

- Subject to corporate level tax under Subchapter L
- Shareholders potentially taxed on dividends

Entity Level Taxation:
Engaged in a US Trade or Business

- Tax imposed on foreign corporations which ‘engage’ in a US ‘trade or business’ or have a U.S. Permanent Establishment
  - Usually inadvertent for a an offshore captive
  - Tax operating guidelines to avoid
- Engaged in a U.S. trade or business – not defined in Code; Courts define as:
    - ‘regular, continuous, substantial’
    - Permanent Establishment (“PE) standard – applicable only to ‘treaty’ countries
  - Effectively connected income
    - IRC §864(b) Exception (Securities trading income)
  - U.S Tax Operating Guidelines – “do’s and don’t’s” to avoid US taxable presence
- Branch Profits Tax
  - PE subject to Branch Profits Tax – 30% or lower treaty (net liability 54.5%)
- May have an impact on Group Captives, “healthcare/non-“d” electing captives

Entity Level Taxation:
IRC §953(d) Election

(‘D’ Company) - Election to be treated as a US insurance company

- Taxed on worldwide income
- Requirements of the ‘d’ election
  - Must be ‘insurance’ company for federal tax purposes
    - >50% of business is issuance (re)insurance or annuity contracts
  - 25% or more shares owned by U.S. Persons (direct/indirect)
  - Revenue Procedure 2003-47
    - Provides guidance/steps for making the election
  - The ‘d’ company must provide “security” to the IRS with one of the following –
    - U.S. Office and Assets Test for the electing Company
    - U.S. Office and Assets Test of a U.S. Affiliate – (State Tax/Regulatory concerns)
    - Line of Credit
  - NOTE:
    - large increases (>20%) to Premium / Investment income may cause issues with the U.S. Office and Assets test
- Election irrevocable without consent
- Cannot re-elect for five years

Entity Level Taxation:
IRC §953(d) Election Advantages

- Exemption from the US federal excise tax on premiums paid to a foreign insurance company
- Exemption from the withholding tax imposed on certain types of fixed and periodic ("FDAP") income from US sources – W-8/W-9
- Exemption from the "branch profits tax" imposed on certain earnings of foreign corporations that are engaged in a US trade or business
- Ability to hold meetings and conduct business activities within the US (Does not alleviate state regulatory concerns)
- Ability to join in filing a consolidated US federal income tax return (if applicable)
  - Must prepare a "stand alone" Form 1120-PC/Form 1120-L
- Ability to more freely invest in US property
- Ability of US shareholders to enjoy the benefit of the dividends-received deduction

Entity Level Taxation:
IRC §953(d) Election Disadvantages

- Potential for double taxation on distributions made to shareholders
  - Corporate Shareholders – Possible Dividends Received Deduction.
  - Non-Corporate – 15% tax.
- Mandatory change of the company’s tax year end to December 31 or the year end of the parent company in consolidation
- Subject to current taxation on worldwide income with no treaty benefits available
- Subject to Dual Consolidated Loss Rules

Entity Level Taxation:
IRC §953(d) Election

- US tax filings
  - 953(d) Election – initial year
    - IRS requires security for payment of US taxes
      - Letter of Credit
      - U.S. office and assets
      - U.S. office and assets met by parent company
  - Annual corporate tax filing
    - Form 1120-PC/Form 1120-L
    - Form 990 for certain “tax exempt” insurance companies
  - Estimated Tax Payments - quarterly

Entity Level Taxation:
IRC §953(d) Election

- US tax filings
  - Form TD F 90-22.1 – annual – if own foreign bank accounts
    - U.S. Persons – Officers and Directors with signature authority
  - Form 720 Quarterly Federal Excise Tax Return
    - Excise tax on amounts ceded to foreign reinsurers
    - 1% on premiums ceded

Entity Level Taxation: ***US domiciled captives***

- US tax filings
  - Annual corporate tax filing
    - Form 1120-PC/Form 1120-L
    - Form 990 for certain “tax exempt” insurance companies
  - Estimated Tax Payments – quarterly
  - Form 720 Quarterly Federal Excise Tax Return
    - Excise tax on amounts ceded to foreign reinsurers
    - 1% on premiums ceded

Shareholder Level Taxation of Captive Insurance Companies

Shareholder Level Taxation:
Controlled Foreign Corporation (CFC)

U.S. has no authority to tax foreign corporations not engaged in a U.S. trade or business

- Controlled Foreign Corporation or “CFC” Rules (1962)
  - Two tier test
    - ‘US Shareholder’ defined
      - 10% or more <u>voting</u> stock
    - ‘US Shareholders’ must collectively own >50% vote or value
    - For “Insurance Income” – special >25% Rule replaces standard >50% Rule
  - Deemed distribution provisions (Subpart F income)
    - Insurance income
    - Foreign personal holding company income (“FPCHI”)
      - Interest, dividends, capital gains, etc.
  - Audit/Accounting issues
    - Generally no tax accrual at the CFC-level
    - ASC 740-10– Determination if a US trade or business or PE

Entity Level Taxation:
IRC §953(c)(3)(C) RPII CFC

('C' Company) - Foreign insurance company may elect to treat RPII (defined later) as effectively connected income

- Typically "Group Captives"
- Requirements
  - Must be 'insurance' company (would be subject to tax under Subchapter L)
  - Must be a CFC (25% or more shares owned by U.S. persons)
  - Election irrevocable without consent
  - Revenue Procedure 2003-47
    - Guidance/steps for making the election
- Same annual US tax filings as a 953(d)-electing company
- VERY RARE

Shareholder Level Taxation:
RPII CFC

Related Person Insurance Income, or "RPII" Rules (1986)

- Defined as insuring the US persons who control or is controlled by the 'insurer'
  - Required RPII / Non-RPII split of management accounts
- 'Any' Shareholder replaces 10% <u>voting</u> shareholder for these purposes
- ≥25% or more replaces the >25% ownership test
- De minimis exceptions
  - Less than 20% RPII
  - Less than 20% vote value held by related persons
- Audit/Accounting issues
  - Generally no tax accrual at the RPII CFC level
  - ASC 740-10 – Determination if a US trade or business

Shareholder Level Taxation: US tax compliance

- U.S. Shareholder
  - Form 5471
    - Category 3
      - Certain contributions – situational, if RPII CFC – annual
    - Category 4 – if Captive is a owned > 50% by a single U.S. Shareholder
    - Category 5 – if Captive is a CFC – annual
      - Inclusion of Subpart F income
  - Form 926 - situational
    - Certain contributions by US person to a foreign corporation
- U.S. Officers and Directors
  - Form 5471 - situational
    - Category 2 – Acquisitions of 10% or more by a U.S. shareholder
      - Failure to file penalty - $10,000 per form per year
- Insured
  - Form 720 - quarterly
    - Federal excise tax ("FET") on US risk to certain foreign (re)insurers
- Protective' return (optional) - annual

Federal Excise Tax ("FET")

US Federal Excise Tax ("FET")
Overview

IRC §§ 4371- 4373

- 4% on direct premiums
- 1% on life, annuity, health, and reinsurance

- Assessed on premiums 'paid'
  - Any party to the transaction is liable for the tax

- Not an ASC 740 issue – FAS 5

- Compliance
  - Form 720 - filed quarterly

Federal Excise Tax (“FET”)

IRS continues its FET initiative

- Voluntary Compliance Initiative (“VCI”)
  - Announcement 2008-18
    - Encouraged foreign reinsurers to comply with historic (pre- Q4 2008) obligations described in Rev Rul 2008-15

- Cascading theory
  - Treaty benefit based on residence of (re)insurer
  - Rev Rul 2008-15
    - US Corp insures risk with ‘treaty-exempt’ Foreign Insurer.
    - Foreign Insurer reinsures with ‘non-treaty exempt’ Foreign Insurer.
    - ‘Conduit Agreement’: FET on both transactions
    - No ‘conduit agreement’: FET on reinsurance transaction

Federal Excise Tax (cont.)

IRS Memorandum - September 14, 2010

- Directs tax examiners to send detailed information of Captive insurance subsidiaries to the IRS International Excise Tax Group, where senior officials will determine within 10 days if the Captive itself should be audited
- IRS stated this announcement, in effect, reissues previous directives to field agents

- U.S. District Court - *Validus Reinsurance Ltd.* - Federal Excise Tax (Case No. 1:13-cv-00109)
  - Court concluded that FET did not apply to “retrocessions” .
  - Appellate briefs filed by the IRS

ASC 740-10

Tax Provisions

Clients that requires a Tax Provision Review:

- Offshore insurance companies that have made an IRC §953(d) election or IRC §953(c)(3)(C) election

- Offshore company which conducts a US trade or business or creates a permanent establishment.

Tax Provisions
Tax Calculation

- "Above the Line"

	Book Income before Taxes*
+/-	Permanent Differences
+/-	Temporary Differences/Deferred Tax Impact
	Current Taxable Income

*Bermuda Statutory: needs to include realized gains (losses)

- "Below the Line"

	Other Comprehensive Income
+/-	Deferred tax impact on unrealized gains/losses
	Net Other Comprehensive Income

Captive Insurance

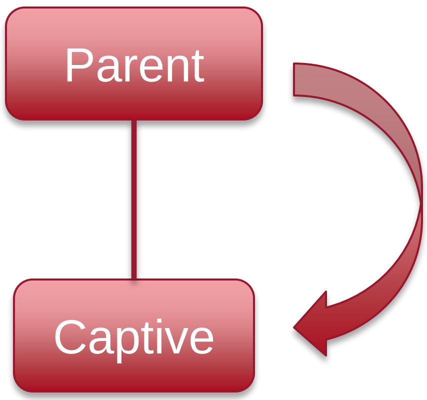
Cases and Rulings on the Definition of "Insurance"

J. Walker Johnson

STEPTOE & JOHNSON LLP

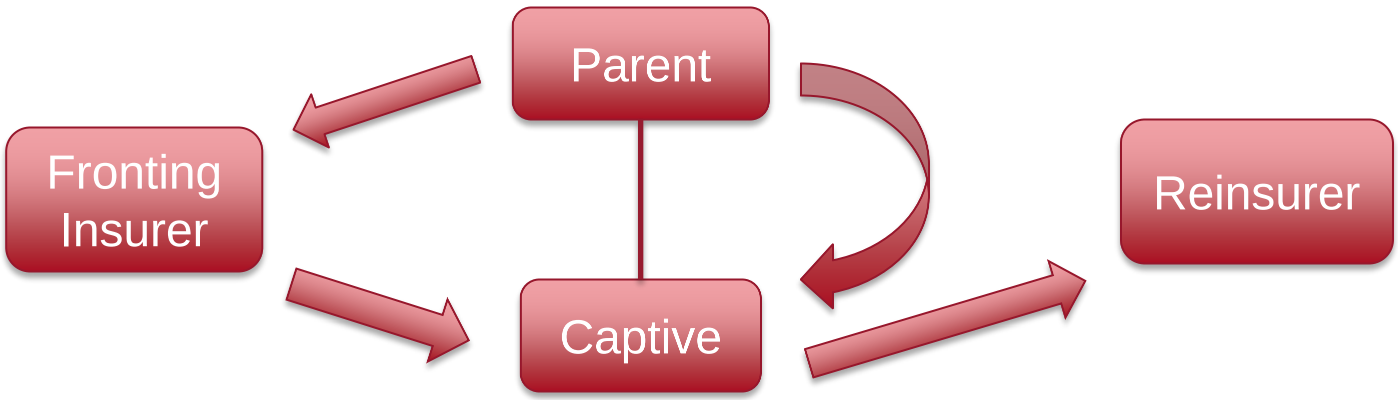
A Basic Issue – Is There Transfer of Risk?

- An arrangement solely between a captive insurance subsidiary and its parent generally does not constitute “insurance.”
- Under *Moline Properties,* the separate existence of the captive is respected.
- But, under the “balance sheet” test, because losses paid by the captive reduce the parent’s net worth, no risk is shifted from the parent.



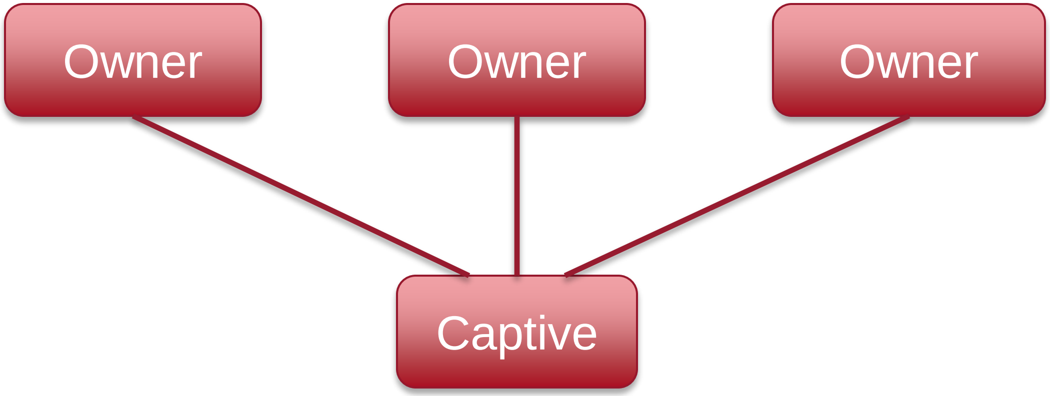
One Solution -- Reinsurance

- The portion of the risk transferred to a third-party reinsurer or retained by a third party fronting insurance company is “insurance.”
- Rev. Rul. 77-316 (Situations 2 and 3); *Carnation;* LTR 9729002.



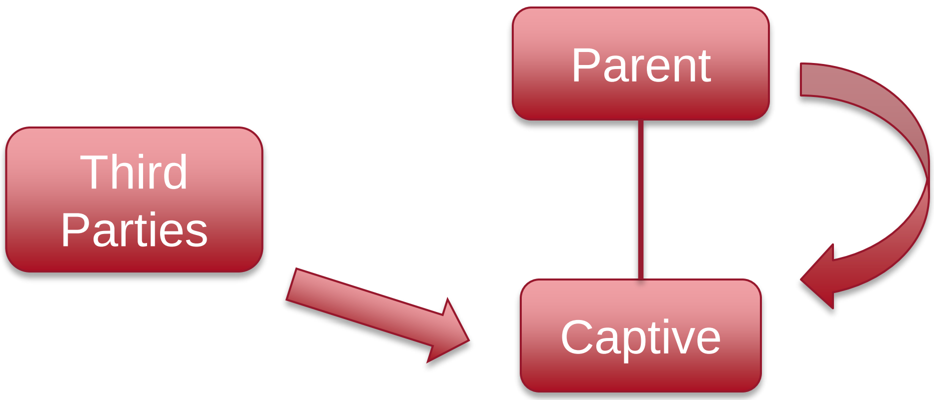
Another Solution – Third-Party Ownership

- If there are a sufficient number of owners, all of the owner-captive arrangements are "insurance."
- Rev. Rul. 2002-91 (a "small group" of owners; no member owns more than 15% of the captive); Rev. Rul. 83-172 (40 owners); Rev. Rul. 80-120 (5000 owners); Rev. Rul. 78-338 (31 owners).



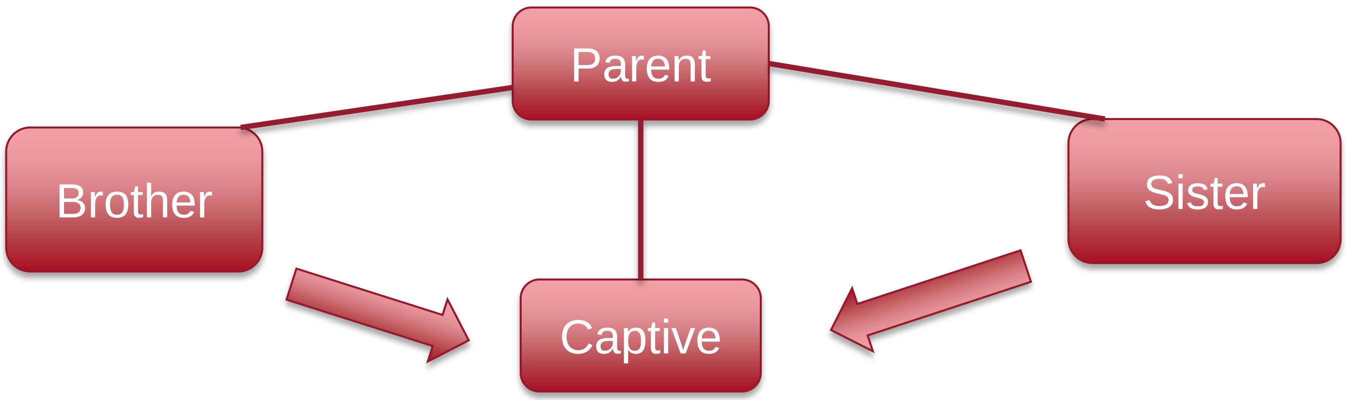
Another Solution – Third-Party Risk

- If a sufficient amount of risk assumed by the captive is third-party risk, the parent's arrangement will be "insurance."
- Rev. Rul. 2002-89: 50% third party risk is sufficient; 10% is insufficient.
- *Sears* (99.75%); *AMERCO* (52-74%); *Harper Group (30%); ODECO (44-64%)*.



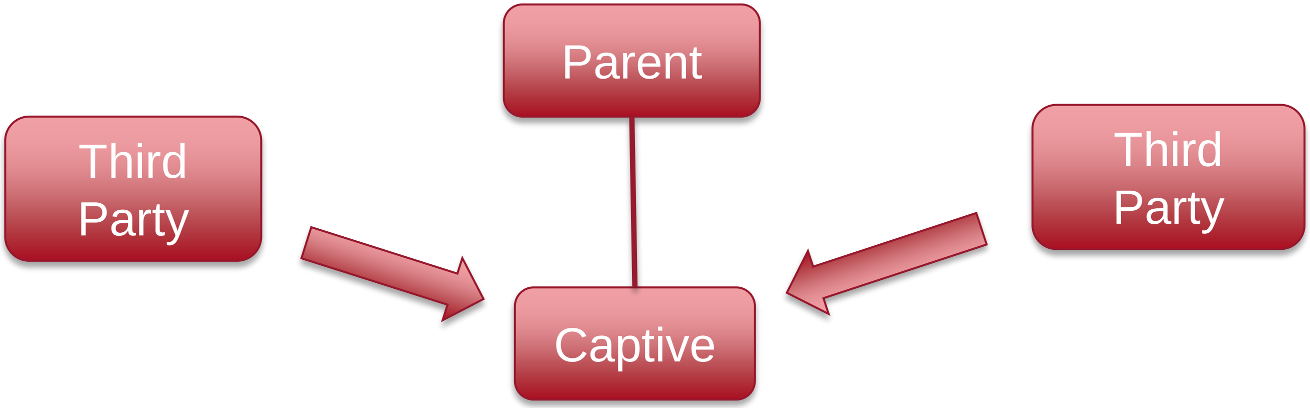
Another Solution – Brother/Sister Entities

- A brother/sister arrangement passes the “balance sheet” test. Losses paid by the captive do not decrease the net worth of the brother/sister.
- Rev. Rul. 2002-90 (12 insured brother/sisters).
- *Humana; Malone & Hyde; HCA; Kidde; Rent-A-Center*.



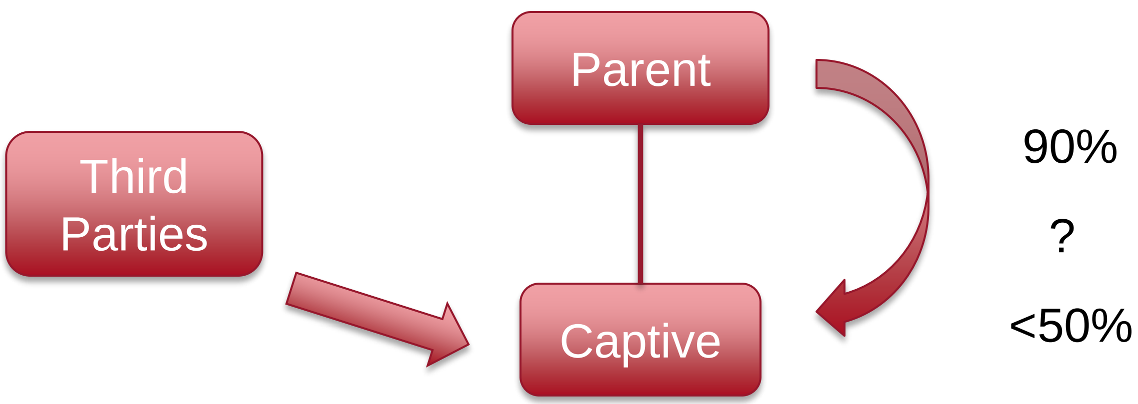
Risk Distribution

- The Service takes the position that once risk is shifted to the captive, that risk must be distributed among multiple insured entities.
- The insurer must insure “numerous relatively small, independent risks.”
- There must be sufficient pooling of premiums “so that a potential insured is not in significant part paying for its own risks.”
- The IRS often notes that the insured risks are “homogeneous.” Rev. Rul. 2008-8; Rev. Rul. 2005-40; Rev. Rul. 2002-89; Rev. Rul. 2002-90.



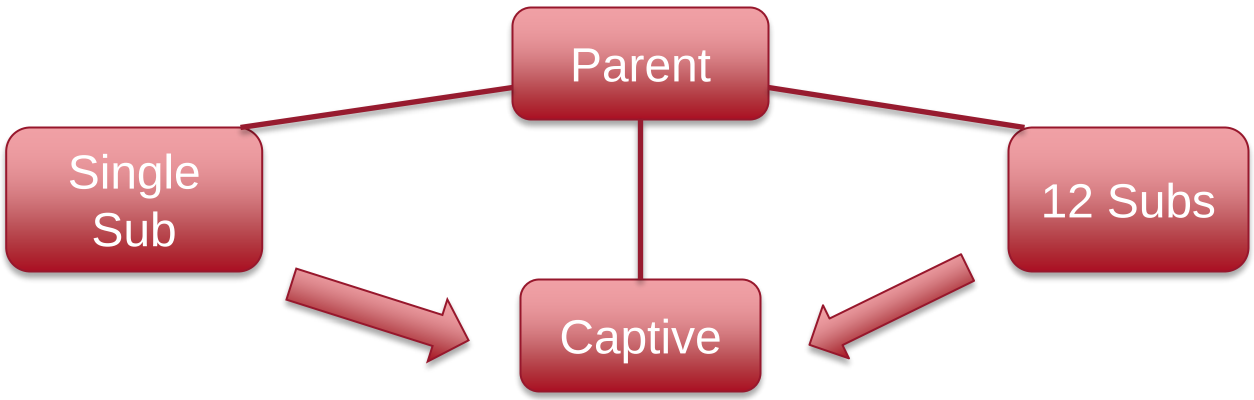
Parent Risk Distribution

- Rev. Rul. 2002-89, Situation #1: If 90% of the captive's risk is parent risk and 10% is from third parties, there is not sufficient risk distribution. See also Rev. Rul. 2005-40.
- Rev. Rul. 2002-89, Situation #2: If less than 50% of the captive's risk is parent risk and more than 50% is from third parties, there is sufficient risk distribution.



Brother/Sister Risk Distribution

- Rev. Rul. 2005-40:   If there is only a single policyholder there is no risk distribution). But, the Tax Court has stated that adequate risk distribution can occur with a “single insured.”
- Rev. Rul. 2002-90 and Rev. Rul. 2005-40: If there are 12 insured brother/sisters, each representing between 5% to 15% of the captive’s total insured risk, there is sufficient risk distribution.



Other Factors Negating “Insurance”

- Lack of insurance risk (no fortuitous event)
  - Rev. Rul. 69-27 (normal business risk)
  - Rev. Rul. 89-96 (after-loss insurance)
  - Rev. Rul. 2007-47 (prefunding arrangement)
  - TAM 201149021 (residual value insurance)
- Lack of valid business purpose
- Noncommercial contract terms
- Non-arm’s length premiums; Inadequate premium allocations
- Experience rating
- Inadequate capital
- Parent guarantee or indemnification
- “Loan back” provision

Captive Insurance – ***Thoughts on Risk Shifting and Distribution***

Dr. Irving H. Plotkin
PWC, Boston
617-530-5332

Captive Insurance – An Overview

- *Helvering v. Le Gierse*, 312 U.S. 531 (1941)
- *Mobil Oil Co. v. United States*, 8 Cl. Ct. 555 (1985)
- *Gulf Oil Corporation v. Commissioner*, 89 T.C. 1010 (1987), aff'd on this issue, 914 F.2d 396 (3d Cir. 1990).
- *Humana Inc. v. Commissioner*, 88 T.C. 197 (1987), *aff'd in part rev'd in part,* 881 F. 2d 247 (6th Cir 1989)
- *Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995)
- Rev. Rul. 2002-90
- Rev. Rul. 2005-40
- *Rent-A-Center, Inc. and Affiliated Subs v. Commissioner*, 142 T.C. 1 (January 14, 2014)
- Rechtbank Zeeland-West-Brabant, Jan. 17, 2014 (but see also Dutch Decree Nov. 2013)

Risk Shifting via Distribution

- If a sufficient amount of risk assumed by the captive is third-party risk, the parent/captive arrangement will be "insurance."
- Rev. Rul. 2002-89: 50% third party risk is sufficient; 10% is insufficient.
- *Sears* (99.75%); *AMERCO* (52-74%); *Harper Group (30%); ODECO (44-64%)*.

Insurance Risk Distribution

"Under principles of the insurance industry, risk transfer and risk distribution occur only when there are sufficient unrelated risks in the pool for the law of large numbers to operate. ... In this instance "unrelated" risks need not be those of unrelated parties; a single insured can have sufficient unrelated risks to achieve adequate risk distribution."

Gulf Oil Corporation v. Commissioner, 89 T.C. 1010 (1987)

[The Tax Court quoted this language with approval in Malone & Hyde]

Insurance Risk Distribution

Perhaps the clearest example of the arbitrary and capricious nature of the IRS's position with respect to the required number of insureds is articulated in RR 2002-90 and repeated in RR 2005-40. These rulings are cited as the justification for the IRS's instant assessment in both the Form 886A and in Respondent's December 3, 2010 Statement of Position in this matter. Respondent's Statement interprets RR 2002-90 as requiring that in order to provide true insurance, the captive must insure at least twelve brothers with each not accounting for less than 5% nor more than 15% of the total insured risks.

Plotkin, Expert Report, Rent-A-Center, Inc. 2014, at 6.

Insurance Risk Distribution

Mirabile dictu, the twelve, 5%, and 15% values are created out of whole cloth. When in formal sessions (not involving this taxpayer) we have asked IRS insurance "specialists" what basis exists in actuarial science or insurance economics for these values, or alternatively what would be different as a matter of insurance theory if there were but ten insureds with some accounting for, say, 20% of the risks, the only answer we received was, "That is our position." A similar stance is evidenced in the instant Form 866A, which, after citing the twelve-insureds requirement of RR 2002-90, declares: "Thus the standard is set at twelve." This absolutist declarative statement brings to mind the same type of logic and "reasoning" found in Nietzsche's Also Sprach Zarathustra.

Plotkin, Expert Report, Rent-A-Center, Inc. 2014, at 6.

Rent-A-Center Decision Re Risk Distribution

C. <u>The Legacy Policies Distributed Risk</u>

Risk distribution occurs when an insurer pools a large enough collection of unrelated risks (i.e., risks that are generally unaffected by the same event or circumstance). *See Humana Inc. & Subs. v. Commissioner*, 881 F.2d at 257 … A captive may achieve adequate risk distribution by insuring only subsidiaries within its affiliated group.

Legacy insured three types of risk: workers' compensation, automobile, and general liability. During the years in issue, RAC's subsidiaries owned between 2,623 and 3,081 stores; had between 14,300 and 19,740 employees; and operated between 7,143 and 8,027 insured vehicles. RAC's subsidiaries operated stores in all 50 States, the District of Columbia, Puerto Rico, and Canada. RAC's subsidiaries had a sufficient number of statistically independent risks. Thus, by insuring RAC's subsidiaries, Legacy achieved adequate risk distribution. *See Humana Inc. & Subs. v. Commissioner, 881 F.2d at 257.*

Rent-A-Center, Inc. at 38 and 39.

OECD BEPS Special Measures

On the topic of a ‘Cash Box’ Arrangement…

I can summarize the [OECD] debate as: U.S. is of the view that wherever the cash is, at whatever the rate of tax is in the country where the cash is, it is entitled to an arm's-length return.

The other side of the debate **is…there can be some application of the arm's-length standard** that I can't articulate, but **that permits you, for example, to give zero return to that cash box.** Similarly, you're hearing people say that if you overcapitalize an entity, you can somehow ignore that transaction.

Those arguments are troubling to the U.S. It's one thing to argue that special measures should apply to a cash box in Bermuda with limited people functions. But move that cash to Ireland with a few more people and a 12.5 percent [corporate tax] rate, then what do you do? We would not be inclined at that point to have these rules carry around the world and start making those kinds of gradations.

Robert Stack, Treasury's Deputy Assistant Secretary for International Tax Affairs, June 2014