



CAPTIVE INSURANCE TAXATION NEWSLETTER

FALL 2007

INTRODUCTION

This edition of the Downs Rachlin Martin PLLC ("DRM") *Captive Insurance Taxation Newsletter* covers recent tax developments affecting the captive insurance industry.

ATTACK ON SINGLE-PARENT CAPTIVES TAXED AS INSURANCE COMPANIES

PROPOSED REGULATION § 1.1502-13(e)(2)(ii)(C)

On September 28, 2007, the IRS released proposed regulation § 1.1502-13(e)(2)(ii)(C) regarding the treatment of insurance transactions among members of a consolidated group. The proposed regulation will directly affect single-parent U.S. captive insurance companies and foreign captives that have made a section 953(d) election, and that are members of a consolidated group with the companies they insure. Most group captives will not be impacted. The industry did not receive advance warning of the proposed regulation and it is opposing the changes.

Current Regulation

Under the current regulations, captive insurance companies that are classified as insurance companies for federal income tax purposes are allowed to take advantage of the insurance company tax benefits for the insurance they provide to companies within their consolidated group; the greatest benefit is a deduction for reserves posted against the risk arising from insureds in the consolidated group¹. The current regulations provide an exception to the general single-entity treatment for intercompany transactions for insurance companies within the consolidated group². The captive insurance company and insureds in the consolidated group are permitted to take into account their insurance transactions as if they were separate entities.

Proposed Regulation

The preamble of the proposed regulation states that "the IRS and the Treasury Department have become aware of the increasing prevalence of captive insurance arrangements with the consolidated groups. Thus, the separate entity treatment of insurance payments from one member of a group to a captive insurance member may now have a greater effect on consolidated taxable income than was anticipated when the current regulations were issued."

¹ Treas. Reg. §§ 1.1502-13(e)(2)(ii)(A) and (B).

² Treas. Reg. § 1.1502-13(e)(2)(ii)(A).

In response to this perceived abuse, the proposed regulations deny separate-entity treatment when five percent or more of a captive's insurance premiums written during the taxable year arise from insuring the risks of other members of the group³. If the captive insures other members of the consolidated group, losses are taken into account under the rules of sections 162 and 461, instead of section 832(b)(5) of the Internal Revenue Code. This means that the captive will not be permitted to take a deduction for its discounted loss reserves. Instead, the captive will have to wait until it pays a claim for a group member's loss to take the deduction. The present value of this timing difference is the negative tax impact of the proposed regulation. Therefore, the longer the "tail" for liability, the greater the negative impact will be on the captive.

Attempts to artificially circumvent the rules by using reinsurance transactions may subject the transaction to the anti-avoidance rules of section 1.1502-13(h). Additionally, the IRS has the power to recharacterize or make other appropriate adjustments to reinsurance agreements between related parties, if the contract has a significant tax avoidance.

If and when the proposed regulation becomes final, it will apply to insurance transactions occurring on or after the date of publication as a final regulation in the Federal Register. Since this regulation applies prospectively, an existing captive insurance company will continue to be able to deduct its existing discounted reserves until it pays the corresponding claims. This means that the captive will essentially run-off its reserves. For insurance transactions from the effective date of the proposed regulation going forward, the captive will be required to comply with the regulation and not take a deduction until the claim is actually paid.

What Now?

In the consolidated return area, Congress granted the IRS broad power to enact legislative regulations, instead of regulations interpreting the Code. The question that many tax practitioners have asked is whether the IRS has overreached its authority by essentially overruling twenty years of case law and guidance. The general consensus of tax practitioners is that the IRS overstepped its authority and is essentially rewriting the Internal Revenue Code, ignoring precedents. The IRS has consistently lost in the courts on the "economic family theory" in addressing whether captive insurance transactions qualify for insurance for federal income tax purposes, and it officially abandoned that position in Revenue Ruling 2001-31, 2001-1 C.B. 1348 (June 4, 2001).⁴ By issuing these proposed regulations, the IRS is attempting an "end-run" and has essentially revived the economic family theory in the consolidated group context.

The Industry's Response

The captive insurance industry, through its various trade associations including the Vermont Captive Insurance Association, has organized and will present a uniform opposition to the proposed regulation. This, however, should not prevent individual companies from submitting comments to the IRS as well. The comment period ends December 27, 2007. Additionally, the Governors of the states with captive insurance legislation have been urged to oppose this regulation. Vermont's Governor is in the process of contacting approximately thirty other Governors from states with this legislation, and urging them to submit an opposition letter.

³ Prop. Treas. Reg. § 1.1502-13(e)(2)(ii)(C)(2)(i).

⁴ The economic family theory was set forth in Revenue Ruling 77-316, 1977-2 C.B. 53. "The ruling explained that the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented one "economic family" for purposes of analyzing whether transactions involved sufficient risk shifting and risk distribution to constitute insurance for federal income tax purposes. See *Helvering v. Le Gierse*, 312 U.S. 531 (1941). The ruling concluded that the transactions were not insurance to the extent that risk was retained within that economic family." Rev. Rul. 2001-31.

If the proposed regulation becomes final, we anticipate that it will not occur until late in 2008, and thereby affect the 2009 tax year. It is uncertain whether the regulation will be modified or withdrawn. Additionally, the length of time before a proposed regulation becomes final sometimes can take many years. This could be the case, because this regulation is just one piece of several proposed regulations. We are, however, hopeful that this matter will be resolved in a more timely manner.



DRM'S CAPTIVE INSURANCE GROUP

The Captive Insurance Group at Downs Rachlin Martin PLLC provides advice to captive insurers (including risk retention groups) and other forms of policyholder-owned alternate risk transfer mechanisms. We have been a leading source of legal advice for Vermont-based entities since 1982, and also advise companies domiciled in other states and offshore.

DRM is a regional law firm, with offices in Burlington, Brattleboro, Montpelier, St. Johnsbury and Manchester, Vermont, and Lebanon and Littleton, New Hampshire. The firm has been serving individuals, businesses, and institutions for more than half a century.

If you have any questions about these or any other captive insurance developments, please contact Kathy Davis or David Angus at (802) 863-2375, or at www.drm.com.