

The Latest from the Tax Front

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Recent IRS Rulings

- Involved a sole proprietor that insured with a captive owned by a trust for the proprietor and his spouse
- The captive reinsured its risks with a Pooling Company (risk mixer entity) which pooled numerous risks and reinsured a proportionate part of several pools (a pool for each coverage)
- No captive in the pool insured more than 15% of the pool's total risks
- Same result in PLR 200907006 (2/13/09)

PLR 201031001 (8/29/10) - Runoff

Company placed in liquidation, previously filed as 501(c)(15)

Since Taxpayer was placed in liquidation, its primary activity has related to the effort to liquidate claims

Pension Funding Equity Act (2004) - It is not intended that a company whose sole activity is the run-off of risks under its insurance contracts be treated as a company other than an insurance company, even if the company has little or no premium income

Therefore, Section 831(b) election upheld

- 4 owner-insureds paid 41.7%, 32%, 13.2% and 13.1% of the premiums to a group mutual
- The IRS determined no insurance because 15% limit of total premiums for a single entity was exceeded
- 15% is a safe harbor in Rev. Rul. 2002-91, not a litmus test
- Litmus test is 1 insured with 90% of the premiums
- In Rev. Rul. 2002-89, a single insured could have 49% of the risk and still not “pay its own losses”
- See also 201025077 (6/25/10) – IRS said no insurance with 69.4% related risks and 30.6% unrelated risks

IRS concluded risk distribution insufficient based on 69.5% of premium from insured “B”, 14.7% from the fronting program and 15.8% from a “reinsurance risk pooling program”

Again illustrates that IRS improperly treats the 15% safe haven enunciated in Revenue Rulings as if it were the law (i.e., statutory)

Issue – Should single member LLCs count as sisters?

IRS says in Rev. Rul. 2005-40 they don't count because they are “disregarded entities” for tax purposes

But this ruling says IRS can't levy on a single member LLC's property for tax obligations of the single member because the sole member has no ownership interest in the LLC's property under local law for collection purposes

If this approach were applied to captive tax situations, then single member LLCs would count as separate sister entities

Taxpayer, denied insurance company status, provided P&C insurance

It entered into 2 types of reinsurance contracts:

- Assumed insurance contracts from an unrelated commercial insurer
- Participated in a “pooling arrangement” in which it insured direct and then reinsured entire book with on a quota share basis with numerous unrelated pool participants

TP relied on Harper Group for idea as much as 71% of premiums can come from a single related party

IRS disagrees stating the 71% in Harper came from 13 brother-sister entities – not only one as in this case

Same result, mixing unrelated and brother-sister doctrines, in PLR 201126036 (9/1/11)

Procedures for excise tax examiners to looking to enforce
“cascading” federal excise tax

IRS plans to audit foreign captive’s affiliates

Instructions to forward all information to IRS international
excise tax group

- Name and EIN of the parent company & captive subsidiary
- Location or country of the captive subsidiary
- Amount of premiums insured with the captive; and
- Amount of premiums reinsured by the captive subsidiary to
reinsurance companies (if known)

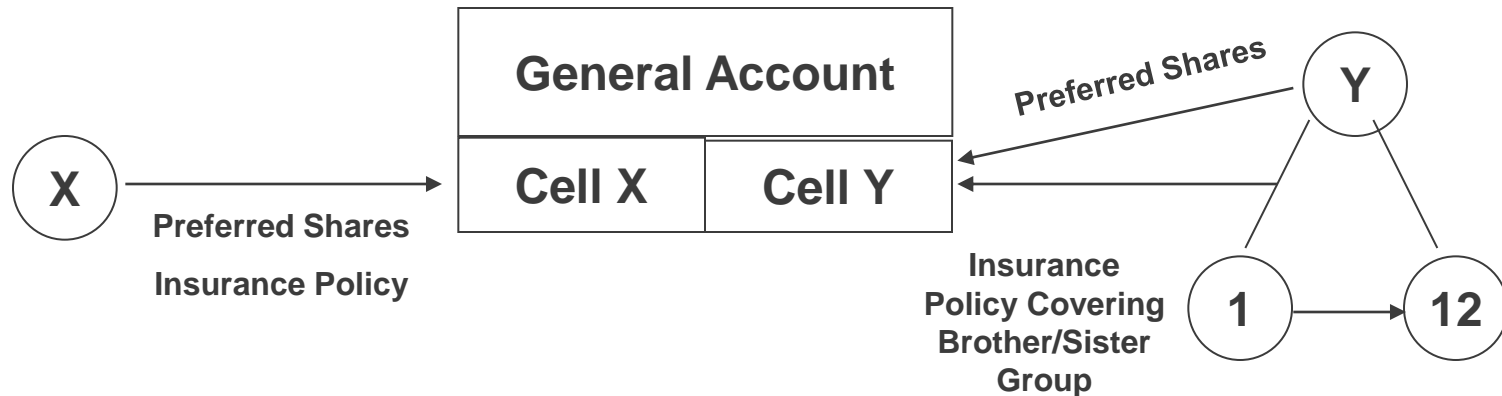
2008 IRS Cell Captive Guidance

POOLED LAYER - CORE CAPITAL



- Concept of separating assets and liabilities in self-contained cells seems valid, but has not yet been judicially tested
- Two key factors to enhance success:
 - Governing law/venue must be the domicile
 - Cell assets (i.e., custody of investments) should be located in the domicile
- Reason: contrary to insolvency principle of horizontal “equitable distribution” (*pari passu*) of assets to creditors; cell structure is a vertical distribution only within the cell
- Pending SAC mutual fund litigation in Bermuda Supreme Court
 - Tensor Endowment Limited vs. New Stream Capital Fund Limited
 - Segregation a peripheral issue, but so far (9/23/10) upheld

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- Pending mortgage guaranty insurance cell insolvency litigation in Wisconsin
 - See Plan of Rehabilitation for the Segregated Account of Ambac Assurance Corporation filed by the Wisconsin Office of the Commissioner of Insurance on 10/8/10 at <http://ambacpolicyholders.com>; plan approved by Dane County Circuit Court on 1/26/11
 - Cell formed on 3/24/10 to sequester certain assets and liabilities under long standing Wisconsin law
 - Issue is whether the IRS and other Ambac creditors can pierce the cell wall
 - Answer is “to be determined”



- No Insured except for X
- No guarantee of Cell X obligations
 - Adequate capital
 - No loans
 - Annual policy
- Adequate capital
- No subsidiary < 5% nor >15%
 - No loans
- No guarantees by Y or Y1 → Y12 of Cell Y obligations
- No other insurance contracts
 - Homogeneous risk
 - Annual policy

Rev. Rul. 2008-8

- Look to existing rules; apply on cellular basis
- Risk shifting
- Risk distribution
- Arrangement between X and Cell X akin to a parent and wholly-owned subsidiary. Rev. Ruls. 2002-89 & 2005-40
- Arrangement between Y and Cell Y characterized as brother/sister insurance. Rev. Rul. 2002-90
- Should have been a 3rd situation in which Cell Z owned by Z wrote >50% unrelated risk with holding of insurance under Rev. Rul. 2002-89

Tax Effect

- Elections at cell level
- Cell must apply for FEIN if subject to U.S. tax
- Cell activities not taken into account in characterizing PCC's "general account" (core)
- Cell (or parent, if consolidated) responsible for filing returns and paying tax
- PCC does not include cell income items

IRS Proposed Regulations Issued 9/13/10

Prop. Treas. Regs – General Rules

- Regs explicitly state they do not address the proper tax characterization or filing requirements of the core

- If a cell is classified as a separate corporate entity, then it will be treated like any other corporation, including the ability to make stand alone tax elections

Prop. Treas. Regs – General Rules

- Regs will not override general tax law principles - for example, if a cell has no business purpose other than tax avoidance, it still will be disregarded as a “sham”

- Regs indicate that ownership of a cell will be determined to be whomever “bears” the economic burdens and benefits of ownership” of the cell (shares=contracts?)

Prop. Treas. Regs: Domestic Cell Captives

- Every cell will be treated as a separate taxpayer, except for segregated asset accounts of a life insurance company
- The fact that state law does not consider the cell to be a separate entity is not important
- Regs cite Vermont and South Carolina cell captive provisions, but this same rule should apply to cell captives formed in all other domestic domiciles with similar laws, including the District of Columbia

Prop. Treas. Regs – Domestic Cell Captives

- The cell's separate entity status will be respected even if the cell fails to comply with statutory record keeping requirements negating the limitation of liability
- The cell's separate entity status will be respected even if, through an arrangement such as guarantees, the debts and liabilities of a cell are enforceable against assets of another cell

Prop. Treas. Regs – Foreign Cell Captives

- Regs state they do not address the proper tax characterization or filing requirements of a foreign cell company or its cells
- But an important exception exists for a foreign cell that conducts an insurance business
- Thus, if the foreign cell's business would qualify it as an insurance company for federal tax purposes had it been a domestic entity, then it will be a stand alone foreign corporation
- Regs cite Guernsey, Cayman and Bermuda cell captive provisions, but the same rule should apply to other offshore domiciles with similar laws

Example #1 – Foreign Insurance Cell

- Assume Foreign CellCo establishes Cell A for a U.S. taxpayer
- Assume more than half of Cell A's business is issuing insurance or reinsurance contracts
- Under the Regs, Cell A will be treated as a separate taxpayer
- Because Cell A qualifies as an insurance company, it will be classified as a foreign corporation

Example #1 – Foreign Insurance Cell

- Cell A's U.S. owner will report Subpart F income using insurance tax accounting (e.g., loss reserve deductions) because he/she bear the burdens & benefits of cell ownership
- Cell A also will be eligible to make tax elections, including under IRC §953(d) and §831(b), on a stand alone basis

Example #2 – Foreign Non-Insurance Cell

- Assume Foreign CellCo establishes Cell B for a U.S. taxpayer
- Assume less than half of Cell B's business is issuing insurance or reinsurance contracts
- Regs state that they don't address Cell B's tax status due to the "novel federal income tax issues" raised
- Cell B will not be eligible to make tax elections, including under IRC §953(d) and §831(b), on a stand alone basis

Transitional Rules

- Cells (domestic or foreign) established prior to September 14, 2010 may be eligible to be treated, together with the core, as a single entity
- Cells are eligible for grandfather treatment if:
 - For a domestic cell, it conducted business or investment activity
 - For a foreign cell, more than half its business was insurance
 - No owner of a cell treated the cell as a separate entity
 - The cell & core had a reasonable basis for its claimed classification
 - Neither the cell nor any owner nor the core was notified before September 14, 2010 that the classification of the cell was under examination
- This exception ceases to apply if there is a change in ownership of 50% or more of the interests in the core (or the cell)

New Cell Annual Reporting Requirement

- Each cell company and each cell within it will annually file a statement with the IRS containing identifying information "to ensure the proper assessment and collection of tax"
- The statement would be a stand-alone filing due March 15
- The IRS sought taxpayer written comments by 12/13/10 on this statement requirement & several other issues, such as:
 - whether a cell is a separate entity if it has no assets or conducts no activities
 - whether a series with no members should still be treated as a separate entity
- Comments still welcome per IRS drafter of the these regs

- ICC = Incorporated Cell Company
- Originated in Jersey (Not New Jersey)
- Adopted by DC in 2009; VT and MT this year
- Legislation proposed in Cayman; Bermuda considering
- By statute, each IC is a distinct legal entity and can have its own governing body (cell walls “higher and thicker”)
- Addresses cell participants’ demand for governance input where core owners don’t want to share power

- Legal relationship between core and its ICs – certainly not a parent/subsidiary; IC tied to its equitable owner
- IC tax status is clear – each IC is a separate taxpayer, ineligible to file a consolidated federal tax return with core, but tax status of core itself is unclear
- Inter-IC and core-IC contracts are valid and enforceable
- Insolvency law status also is clearer – each cell is a separate juridical person; usual rules to apply creditor hierarchy only within the IC; must apply “piercing the corporate veil” case law to cut through IC wall

IRS Taxpayer Audit Activity

Common IRS Captive Audit Issues

- Alleged lack of risk distribution (i.e., over concentration of risk in one entity)
- Application of risk distribution requirements to pass-thru entities (LLCs, partnerships, Q-subs, etc.)
- Treatment of revenue rulings as imposing statutory rules rather than as the safe harbors much of the IRS concedes they are
- Allegations that capitalization of captive using a bank letter of credit constitutes a parent guaranty

Common IRS Captive Audit Issues

- Tax recognition of “risk mixers” as legitimate generators of unrelated risk
- Attempts to bifurcate premiums such that amounts not sent to “risk mixer” treated as non-deductible
- Nature and scope of permissible loans from captive to its parent or affiliates
- Attempts to apply risk distribution on a line of business basis (the “homogeneity” issue)
- In determining unrelated risk, application of “look thru” approach (e.g. in medical stop loss coverage, looking thru the employer to employees as generators of the underlying employee benefits exposures) – note just added to the IRS 2011-12 work plan of issues to address

Common IRS Captive Audit Issues

- Whether the risks written by the insurer are “insurance risks” or “business risks” for federal income tax purposes
- Business purpose for the captive – IRS agent certainly will request and read the original feasibility study
- The agents many times will have little or no knowledge of captive operations – excise tax examiners even less than income tax examiners
- Examiners often use a checklist indicating the types of information they should look at and will tend to focus on the factors set forth in revenue rulings

IRS Lists Key Audit Targets

Unofficial IRS Captive Audit Considerations

1. Consider whether the risks are garden-variety insurance risks or unique risks that require further investigation into whether the risks are insurance risk.
2. Was a feasibility study performed showing business benefits? The IRS is more likely to “find an adjustment” with a taxpayer that does not follow good business practice.
3. Assess whether the assuming company has the capacity to assume the risk. Look at the premium to surplus ratio. Are there any parental guarantees? What is the maximum single risk exposure compared to surplus.

Unofficial IRS Captive Audit Considerations

4. Consider whether there are sufficient exposure units for risk to be reasonably predictable (law of large numbers).
5. Consider whether the insured is in substantial part paying for their own losses, by comparing the relationship of the largest insured as measured by premiums to total premiums.
6. Assess whether the Captive is operating as an independent entity and whether there is insurance in its generally accepted sense. Part of this is the question; could the Captive still function if its largest investment failed?

Unofficial IRS Captive Audit Considerations

7. Is there a loss portfolio transfer and is there a significant chance of a significant loss as required for GAAP under FASB 113?
8. If parent premiums are deducted, determine whether there is a sufficient amount of unrelated risk assumed by the Captive.
9. Is the taxpayer taking a consistent position by paying excise tax for risk ceded to an offshore insurance company that is not taxed as a U.S. taxpayer?

Unofficial IRS Captive Audit Considerations

10. Did the Captive enter into a finite risk contract with an offshore reinsurance company that is a non-Controlled Foreign Corporation? If so, review the transaction to determine whether there is significant tax avoidance.
11. Are Captive assets used as security or as compensating balance for the liabilities of another entity?

Lines of Captive Coverage – Insurance or Business Risk?

Traditional Captive Lines

- General liability (I)
- Professional and products liability (I)
- Auto liability (I)
- Director and officer liability (I)
- Employment practices liability (I)
- Environmental liability (I)
- Workers' compensation (I)
- Product or service extended warranty (I)
- Property and business interruption (I)

Expanded Captive Lines

- Employee Benefits (ERISA and non-ERISA) (I – 3rd Party?)
- TRIPRA (Terrorism Risk Insurance Act) (I)
- Surety bonds and fiduciary risk (?)
- Shipping coverages (I)
- Title and private mortgage insurance (I)
- Equipment maintenance (I)

Expanded Captive Lines

- Construction exposures (CCIPs – Contractor Controlled Insurance Programs and OCIPs – Owner Controlled Insurance Programs) (I)
- Trade credit risk (?)
- Cyber-risk (e.g., website hackers and attackers) (I)
- Managed care errors and omissions (I)
- Employees' personal lines (auto, homeowners, etc.) (I)

Emerging/Exotic Captive Lines

- Self-insured medical stop-loss (non-ERISA) (I)
- Reputational/brand/loss of income risks (?)
- Intellectual property (patent, trademark, copyright) (?)
- Product recall coverage (I)
- Medicare “fraud and abuse” insurance (?)
- HIPPA breach of privacy, protected medical data security (I)
- Expert witness testimony coverage (?)

Emerging/Exotic Captive Lines

- Tax audit insurance (?)
- Lease residual value risk (B)
- Punitive damages coverage (?)
- International kidnapping protection (I)
- Longevity risk (pension plans and annuity issuers) (?)
- Customer returns of retail products (e.g., LL Bean liberal “no questions asked” policy) (?)

Questions