

Going round in circles

With captives there are several *sine qua non*s. This article focuses on two of them; namely that a captive must be able to operate – and indeed does operate – as an independent entity (separate and apart from its insureds or owners), and that it must rest on a sound financial footing.

In *Moline Properties* (319 U.S. 436 (1943)), the US Supreme Court sets forth the still-vibrant rule that unless a corporation is a sham it must be viewed and respected as a separate taxable and corporate entity, and that transactions between related parties must be recognised as valid if there is some economic substance to the transaction and the essential elements of arm's length bargaining are present.

How does the 'Moline rationale' come into play with respect to inter-company loan arrangements involving a captive? First, we note Treasury Regulation 1.461-4(g)(1)(ii)(A), which states the following in the context of the 'economic performance' requirement that has to be met before an accrual basis taxpayer can take a deduction for an accrued liability: "The term payment has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has



made a payment...payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a government agency)...."

Short-term loan

So if a premium payment by an insured to a captive insurer was financed by a loan by the captive to the insured, then no payment will be deemed to have been made by the insured, as the insured delivered its own debt obligation in lieu of actual payment. However, in the context of typical arrangements involving a captive and members of a controlled group, what if the captive were to make a short-term loan to its parent that had no risks insured by the captive? What if the loan were to a related non-parent insured, but having no connection to a premium payment owed by the insured, in terms of either timing or amount? What if the loan were to a dedicated finance subsidiary in the captive's control group? Apart from 'payment' issues, do such loans affect the basic integrity of the captive?

In the Field Service Advisory 20020202, in describing various factors affecting the legitimacy of a captive, the Internal Revenue Services (IRS) states: "Loaning out substantially all of its assets to an affiliate, insurance subsidiary resembles an incorporated pocket-book, representing a reserve for self-insurance...."

In FSA 199945009 in a similar view, the IRS noted: "With respect to the loans from 'C' to 'H', we first note that the terms of the loans are not included with your submission. Depending upon the facts of a particular case, the presence of circular flows of cash may indicate self-dealing, and could undermine a taxpayer's argument that the captive insurer was an independent entity that negotiated the terms of the 'insurance' transactions at arm's length. Since the facts concerning these loans between 'C' and 'H' are

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Are loanbacks an acceptable part of the captive and parent relationship? Answers vary between yes, maybe and absolutely not. Phillip England, John Hess and Isaac Druker attempt to clarify the issue

Loanbacks

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not clear, we cannot determine whether the resulting circular cash flows affect whether the transactions at issue are ‘insurance’.”

In Rev. Rul. 2002-90 the IRS noted, among the relevant factors indicating that payments were deductible insurance premiums, that the captive did not loan any funds to its parent or related party insured.

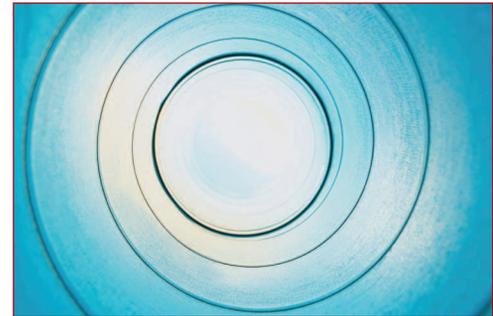
Legitimising loanbacks

The question is whether loanbacks and circular cash flow transactions merely militate against the legitimacy of a captive or do the Section 461 regulations absolutely foreclose any loan to an insured (as opposed to, for example, the factoring by a captive of an affiliate’s receivables due from third parties, or a captive loan to a non-insured affiliate)? Unfortunately, the answer is somewhat unclear and depends upon particular facts and circumstances, but a couple of points can be made.

Generally, in any transaction involving related entities, the existence of circular cashflow (for example, an arrangement where value has not been effectively or in substance transferred) is something to be avoided. The economic substance of the underlying transaction becomes suspect unless there are separate business reasons (or justifiable investment decisions) for each leg of an inter-company transaction that involves the movement of cash back and forth among related parties. Particularly in cases involving a captive, any loanbacks or analogous transactions with an insured or other affiliate must be consistent with the furnishing of insurance coverage, for example, the business of insurer.

The bottom line

The bottom line may be that in the context of a captive, some loans within the controlled group by a captive should be acceptable



(remember in FSA 200202002 the IRS highlighted the loaning out of substantially all of a captive’s assets). There is no specific guidance on what level of loanbacks would be acceptable. However, a direct loan to a related insured (or an affiliate that merely re-lends to such insured) would raise the issue of actuality of ‘payment’ noted in the regulation cited above, and *Moline Properties* might not be an effective defence to an IRS challenge.

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