

Captive Confusion

by Robert Horkovich, Phillip England and Randall Beckie

In the August 2008 issue of *Risk Management*, we wrote that the U.S. tax treatment of rent-a-captives (aka “cell captives”) had been demystified by Revenue Ruling 2008-8 (“Rent-a-Captive Taxes Demystified”). Since then, some captive insurance tax advisers have said that the clarity offered by this ruling is not yet effective. Differing views about the tax treatment of cell captives have created a present and pressing dilemma for captive managers and cell captive participants. What to believe?

As background, in a typical cell captive structure, a sponsor forms an offshore segregated account company (SAC) that consists of segregated cells. The SAC effectively leases each cell to a participant to conduct insurance business within. The sponsor provides captive management services to the cell for a fee. Under applicable law, the cell has license to write related-party insurance risk or to reinsure unrelated risk. The SAC typically owns the cell’s common voting stock, while the cell’s participant owns preferred stock or an analogous right of participation. Preferred stock dividends track the cell’s net income. Each cell’s assets and liabilities are insulated from other cells and the sponsor.

Prior to Rev. Rul. 2008-8, there was room for disagreement about whether a cell could achieve insurance company status independently of the SAC (“yes,” per the ruling). It was also unclear if the SAC could say it is an insurance company based on the activity of its cells, even though cells’ activity is walled off from the SAC (“no,” per the ruling).

Amidst the ambiguity, a popular interpretation ran as follows: The SAC treated itself as a foreign insurance company, all of whose underwriting income was attributable to the various cells. The cell participant would claim a tax deduction for the purported insurance premium paid to the cell on grounds that the SAC (if not the cell) qualified as an insurance company. This interpretation wished away the problem of insufficient risk distribution at the cell level. Historically, a cell that did have sufficient risk distribution took the position of filing a separate insurance company tax return, but few such situations existed.

The cell participant would treat its cell’s underwriting income as undistributed income of a non-controlled foreign corporation (non-CFC), as if the income belonged to the SAC. Meanwhile, the SAC would issue the cell owner a Form 5471 (Information Return of U.S. Persons with Respect to CFCs) as if the cell constituted a CFC, in which the cell’s participant would receive a

dividend of the cell’s current income. The SAC’s handling of this was inconsistent because viewing the cell as a CFC presumed that the cell was independently an insurance company. This inconsistency is the analytical problem that Rev. Rul. 2008-8 corrects.

IRS Notice 2008-19, which was issued alongside Rev. Rul. 2008-8, proposed guidance about how a qualifying cell could make a Section 953(d) “domestic” election and file a separate tax return. Confusingly, the notice also said such proposed guidance would not become effective until after the IRS issued further guidance in final form. Read literally, the notice insinuates that a cell cannot yet be treated as a separate insurance company. If one were to ask the drafter of the notice what meaning was intended, however, in all likelihood he or she would confirm that Rev. Rul. 2008-8 was applicable upon issuance and that the analytical framework in Rev. Rul. 2008-8 compels the interpretation that a cell captive, if it meets definitional requirements as an insurance company, should treat itself as a separate insurance company for tax purposes.

For cell participants, the consequence of Rev. Rul. 2008-8 would be to deny deductions for premiums paid to a cell that fails to qualify as a separate insurance company. Furthermore, a nonqualifying cell’s investment income would be taxable to the cell’s participant. Considering that Rev. Rul. 2008-8 validates a correct interpretation that was available to taxpayers all along, the rulings’ implications logically should be effective immediately if not retroactively.

Gone are the days when a tax adviser could say, in the name of conservatism, that authority was not near enough on point to treat a qualifying cell as a separate insurance company. Rev. Rul. 2008-8 has current efficacy precisely because the authority and reasoning behind it existed prior to that ruling. Rev. Rul. 2008-8 serves as a reminder that in the captive tax advisory business, saying “no” or “not yet” sometimes can be over-cautious to the point of being incorrect. ■

