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The Captive Report

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Proposed Captive Tax Regulations To Affect Consolidated Groups

On September 28, 2007, the U.S. Treasury Department issued proposed regulations that, if adopted in 2008 or later, would eliminate consolidated tax return deductions for captive insurance reserves for related party risk. The proposed regulations essentially would write the economic family theory into the consolidated return rules under reg. § 1.1502-13.

Scope of Potential Impact

The proposed regs seemingly would apply only where a captive is included in a U.S. consolidated income tax return. A consolidated return includes C corporations that are at least 80% owned by a common parent, directly or indirectly. S corporations, foreign corporations, partnerships, LLCs that are treated as partnerships, trusts and individuals are ineligible to be members of an affiliated group that files a consolidated tax return.

A controlled foreign corporation that is an insurance company may make a § 953(d) election (domestic election) to be treated as a U.S. corporation. A 953(d) electing company would be included in its parent's U.S. consolidated tax return if the parent is a C corporation that has elected to consolidate. However, if the 953(d) company is not 80% or more owned by a C corporation parent that has elected to consolidate, the proposed regs should not affect the 953(d) company.

Shareholders of many closely-held companies have structured ownership of their captive insurance company to avoid inclusion in a consolidated group. Closely held companies often are organized as S corporations or partnerships rather than as C corporations. Captive insurance companies may be owned by family members, by trusts for the benefit of family members, by S corporations or by partnerships. These types of ownership structures should be outside the scope of the proposed regs.

Captive management service companies are circulating client alert letters that could be read to suggest that as a general proposition foreign captives and 953(d) captives may have something to worry about in consequence of the proposed regulations. This is not true. Outside of a U.S. consolidated tax return context, the proposed regs have no effect.

Nature of Impact on Consolidated Groups

Current regulations under § 1.1502-13 generally impose a matching rule on the accounting for intercompany transactions. Matched accounting is determined by treating separate subsidiaries as divisions of the same company. Adoption of tax accounting methods generally happens at the separate entity level, which means that separate subsidiaries within a consolidated group may have inconsistent accounting methods. Recasting separate subsidiaries as divisions is a way to sort out the mismatches in their accounting methods. However, the current regulations contain an exception from the matching principle for intercompany insurance transactions. For intercompany insurance, the insurance subsidiary is permitted to maintain separate accounting on an insurance company basis under § 832, whereas affiliated insureds account for premium expense under the economic performance rules of § 461. The result is that intercompany premiums can have mismatched tax accounting: the insured may deduct the premium when paid (per the 12 month rule of reg. § 1.263(a)-4(f)), while the insurance subsidiary defers the recognition of premium income until the premium is earned ratably over the policy coverage period. Likewise, the insurance subsidiary may deduct reserves for unpaid losses, which is a more advantageous method than a non-insurance company could use. Pursuant to § 461, a non-insurance company generally cannot deduct contingent liabilities for unpaid losses until the losses are paid.

The proposed regulations would remove the intercompany insurance exception from the matching rules in situations where insurance reserves arise from related-party risk (specifically, from other members in the consolidated return group). However, if more than 95% of an insurer's net written premiums come from unrelated insureds (as is typical of a commercial insurance company), the insurer can still deduct reserves for related-party risks in tax consolidation. "Net written premiums" means gross premiums written on insurance contracts during the taxable year minus return premiums and minus premiums paid for reinsurance. As a practical matter, the 5% related-party de minimis rule narrows the applicability of the proposed regs to captives while leaving commercial insurance companies unaffected.

Here is an example of how the 5% de minimis rule would work: When Sears owned Allstate, Allstate received 0.25% of its premiums from Sears and 99.75% from unrelated parties. See *Sears, Roebuck v. Comm.*, 972 F.2d 858 (7th Cir. 1992). Applied to that fact pattern, the proposed regs would allow Allstate to deduct reserves for losses on its policy with Sears because Sears' premiums are less than 5% of Allstate's net written premiums. The proposed regs would take effect for consolidated tax years beginning on or after the date final regulations are published in the Federal Register. Thus if final regs are adopted sometime during 2008 at the earliest, for a calendar year taxpayer the regs would become effective in 2009 at the earliest.

Most tax consolidated captives receive virtually all of their premiums from other members of the consolidated group. In keeping with the matching principle mechanism for non-insurance companies, the proposed regs would apply the matching principle to intercompany insurance by treating the insurance subsidiary and its affiliated insureds as though they are divisions of the same company. Since interdivisional underwriting amounts to self-insurance, not insurance, insurance company accounting would be eliminated with respect to related-party risk.

Via the proposed changes to the consolidated return regulations, Treasury would accomplish in limited scope what the courts have long prevented the IRS from doing: namely, treating captives and related-party insureds as members of same economic family. Under the IRS' economic family theory as articulated in Rev. Rul. 77-316, related-party insurance is recast as self-insurance in substance, with the result of dismantling insurance company accounting for reserves. From 1989 through 1997, the courts rejected the economic family theory, citing a conflict with the separate entity doctrine per *Moline Properties*. Conceding defeat, the IRS formally abandoned the economic family theory in Rev. Rul. 2001-31 and re-drew the captive insurance tax battleground to address 20 insurance definitional issues that are raised in Rev. Ruls. 2002-89, 2002-90, 2002-91 and 2005-40.

Insofar as an insurance subsidiary's reserves arise from risk of unrelated parties, traditional insurance company reserve accounting would continue to be allowed and respected for tax purposes. The proposed regs basically do not affect reserves for unrelated business. The unrelated risk exception allows producer-owned reinsurance companies to continue to use insurance company reserve accounting in a consolidated return. Thus, if a bank owns a mortgage guaranty reinsurance subsidiary that insures default risks on mortgages that the bank originates, the reinsurance subsidiary's reserves are deductible in tax consolidation with the bank. Producer-owned reinsurance companies are also commonly used to enable manufacturers, builders and retailers to participate in extended warranty insurance underwriting for homes, vehicles and appliances, and such risk is generally unrelated risk. Unrelated risk also includes employer-paid accident & health risk (see Rev. Rul. 92-93) because of a look-through rule that treats employees as the insureds even where the employer pays the premium to the captive directly.

The proposed regs appear to adopt a look-through rule for determining the source of risk (related vs. unrelated). The proposed regs contemplate that a non-insurance member of a group could issue an insurance contract, then cede the contract to an insurance affiliate. For example, a car dealer might issue a vehicle service contract to a consumer. The vehicle service contract is treated as a contract of insurance for federal tax purposes, although this does not make the car dealer an insurance company. If the car dealer subsequently transfers the vehicle service contract to a consolidated reinsurance subsidiary, the reinsurance subsidiary may treat the vehicle service contract risk as unrelated party risk by looking through to the consumer as the ultimate insured. Putting this look-through rule in the proposed regs apparently formalizes the IRS' interpretation in Technical Advice Memoranda 200453012 and 200453013, a landmark taxpayer victory for thousands of car dealers that own private reinsurance companies.

Commercial intercompany reinsurance transactions, which are routine among licensed commercial insurance companies, should be unaffected by the proposed regulations because commercially underwritten risk generally is unrelated risk.

Anti-avoidance Regulations

If the proposed regs are adopted as drafted, the IRS presumably would rely on an existing anti-avoidance rule under reg. § 1.1502-13(h) to thwart attempts to restructure around the consolidated return matching rule for intercompany insurance. Considering that under the proposed regs a consolidated group may face disallowance of reserve deductions simply because the captive is consolidated, the obvious response will be to de-consolidate the captive. There are several ways to remove a captive from a consolidated group by restructuring the chain of ownership or moving domicile offshore. The anti-avoidance rules may apply where a principal purpose of the restructuring is to avoid federal tax, including avoidance of the consolidated return regulations. However, it is not at all clear how much leeway the IRS would have in a determination of whether tax avoidance rises to the level of a principal purpose of a restructuring. At the very least, tax directors of consolidated groups with captives will be especially attentive to non-federal tax reasons for restructuring their captive insurance arrangements.

As drafted, the proposed regs apply to intercompany insurance contracts written directly from the insurance subsidiary to the insured affiliate. Indeed, the consolidated return regulations govern intercompany transactions, not transactions with unrelated parties; therefore, the language of the proposed regs could not be aimed at disallowing reserve deductions for any risks that a captive assumes via reinsurance. However, the preamble clarifies that the proposed regs may also apply to reinsurance of related-party risk. The preamble cites the anti-avoidance rule of 1.1502-13(h) as the mechanism by which reinsurance of related-party risk could be subject to the matching rule in the same way as direct insurance of related-party risk. It is common for captives to reinsure related-party risk for workers' compensation and commercial automobile liability from a commercial insurance company (a fronting company). If Treasury's intent is to disallow captive insurance reserves for fronted related-party risk as a matter of course, it would seem that the IRS' enforcement tool would be to invoke 1.1502-13(h) routinely, potentially even where the original and principal purpose of fronted reinsurance is to retain risk within the consolidated group, not avoid taxes. It is unclear whether the IRS would be able to sustain disallowance of captive reserves for reinsured related party risk without a clear showing of tax avoidance intent.

Captive Insurance Industry Response

The proposed regulations invite public comment. Comments are due by December 27, 2007. Groups such as the Vermont Captive Insurance Association may be inclined to point out that the captive insurance industry is big business that creates jobs for Americans, whereas the proposed regs encourage formation of captives offshore. Commentators may find Treasury's motive curious: In the preamble to the proposed regs, Treasury says the existing (1995) regulations excepted intercompany insurance transactions from the matching principle because at that time Treasury did not foresee a significant revenue drain from captive insurance arrangements. But how can the proliferation of captives come as a surprise to the government, considering that Congress two decades ago enacted § 953(d) to level the already large and growing playing field for domestic and offshore captives?

The proposed regs are very recent. Reactions from taxpayers and industry groups may take some time to be articulated. Among initial reactions, many captive insurance advisors and captive owners are quite concerned that Treasury would resurrect the economic family theory so long after the courts repudiated it. However, the proposed regs take a clever approach around the *Moline Properties* doctrine: the proposed regs continue to allow intercompany underwriting to meet the definition of "insurance" while dismantling merely the accounting for insurance as such in tax consolidation. The proposed regs would shut down an exception from the matching principle, and it was Treasury that created the exception in the existing consolidated return regulations in the first place.

Congress has delegated authority to Treasury to write consolidated return regulations. As consolidated return regulations are legislative regulations, not merely interpretive regulations, the courts have generally been reluctant to hold them invalid. However, to be valid, a consolidated return regulation must foster a clear reflection of income. There is room for doubt about whether the proposed regs meet this test, considering that they would penalize consolidated groups by disallowing insurance company accounting while insurance company accounting would remain allowable outside of a consolidate return context. In 2004, Congress expanded Treasury's authority to issue regulations that result in potentially uneven treatment of consolidated groups versus non-consolidated taxpayers. It remains to be seen whether Treasury's newfound authority goes so far as to brand captive insurance as a problem just because a captive is included in a consolidated return.

Whether the proposed regs constitute prudent government policy is another open question. Perhaps the proposed regs will dent the growth of the captive insurance industry, or perhaps the proposed regs will merely encourage planners to try harder.

Anderson Kill will be commenting. Please share your feedback with us.

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