An Introduction To Captives

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CAPTIVE INSURANCE: AN INTRODUCTION

A captive insurance company is simply an insurance company that writes insurance business to an affiliated business entity, the captive insurance industry has grown tremendously over the past 30 years. Thousands of businesses have witnessed great benefits from the use of "captives." Such businesses include Microsoft, UPS, Humana, McDonalds, to name a few. With the growth of many foreign and domestic captive domiciles, and a favorable regulatory environment, we believe that there has never been a better time to form and operate a captive.

The U.S. tax law regarding insurance companies and insurance itself dates back over 70 years. Over this period, several key concepts have endured, such as risk distribution and risk transfer. A third concept that has developed is that the captive insurance must resemble insurance in its traditional sense.

These three concepts - risk distribution, risk transfer and "traditional notions" of insurance – form the "core" of the law regarding captive insurance.

This Memorandum contains what we consider to be important areas of captive insurance tax law for captives desiring to be taxed as a U.S. insurance company. This Memorandum is not meant to be a substitute for independent review by the client's tax professional, but rather to help the client judge the suitability, risks and operational issues regarding the ownership and operation of an insurance company.

This Memorandum will make you, as a trusted advisor to your current client base, aware of many of the various tax issues surrounding captive insurance. Tax law may change over time, and so portions of this Memorandum may become outdated, and we assume no responsibility for updating this Memorandum as the law changes. This Memorandum primarily deals with tax issues regarding captive insurance, although some operational issues are discussed as well. Not all issues regarding the ownership and operation of an insurance company are discussed herein. While this Memorandum will outline the tax law and some general principles regarding insurance companies, the application of the law and such principles to any particular captive company is subject to interpretation.

THE GROWING CAPTIVE MARKET

Captive insurance companies have been a popular business tool for many years. While captives, for the most part, were initially used only by large multinationals, the concept has caught on, and today captives are found in a wide variety of business endeavors. There are now over 6,500 captive insurance companies worldwide, representing over $60 billion in premium.

Captive insurance companies represent a significant component of the alternative risk market. Due to their growth, strength, and utility over the past decade, captive insurance companies are no longer considered by many insurance professionals to be a truly "alternative" insurance market. The use of a captive is now seen as an integral part of general business risk management for successful companies.

Among the many benefits of using captives may be some tax benefits. For example, a company that is currently self-funding a layer of exposure for workers' compensation risks may choose to provide for this exposure through a captive. The company could then deduct the premiums paid to the captive, rather than deferring the deduction under the self-funding plan until the claims are actually paid. This gives the business a current tax deduction, rather than a deduction spread out over several years.

Captive insurance became popular in the 1970s when large companies started using captives to get around a "hard" market in which insurance premiums were very costly. This phenomenon has reappeared from time to time. In addition, captives provide risk management benefits. The business reasons for creating a captive insurance company include the following:

- Obtaining coverage when commercial insurers are unwilling, impractical, or not dependable. Commercial insurance companies often will not provide some types of coverage. For instance, risks that are currently uninsurable frequently involve environmental issues, such as hazardous

waste, nuclear risks, risks relating to acts of terrorism, intentional acts, and pollution. Captives can be used to provide coverage in these areas.

- Reduced premium payments. Creating a captive enables the parent to reduce certain costs that are often added to the premium by a commercial insurer, allowing the parent to obtain the same coverage at a lower cost. These costs include general overhead, administration and settlement of claims, taxes, brokerage fees, and miscellaneous fees.

- Control of Claims. With a captive, the risk management of the entire enterprise can be controlled. Claims can now be handled and managed according to what is best for the enterprise, and not simply best for the large insurance carrier. With a captive, businesses will manage insurance claims much more effectively when the claim is to be paid by a business affiliate (i.e., the captive), and not an unrelated insurance carrier.

- Control of risk. Effective risk management allows a captive to control subsequent losses. Net retention can be adjusted as market conditions change to achieve cost effective risks.

- Cash flow. The commercial insurance industry has traditionally relied on investments as a primary source of income. With a captive, this investment income is now captured by the business enterprise.

- Access to reinsurance market. A captive may gain direct access to the international reinsurance market, i.e., the wholesale market for insurance. Frequently, captives are able to obtain reinsurance that is less expensive than the reinsurance available in the commercial market. Access to the reinsurance market can generally be accomplished only through a licensed insurer.

- Diversification into a profit center. A parent cannot insure its risks in a wholly owned captive unless the captive holds some amount of third-party risk. The sale of insurance to third parties provides leverage if the parent holds most of the risks. It is possible for a captive to diversify and offer insurance services to independent third parties and operate as a separate commercial profit center. This will not only allow the captive to generate more investment income, but will also provide more risk distribution.

- Balanced coverage. Economic fluctuations, poor underwriting, and normal commercial industry changes often lead to significantly increased premiums in commercial insurance. Captives are less affected by these external factors and thus have steadier premiums that can be factored into the parent's long-term budget, allowing the parent to be in a better position to reach its financial target.

INSURANCE, REINSURANCE, CAPTIVE INSURANCE

The primary purpose of insurance is the transfer and spreading of risks. Insurance companies collect premiums relating to insurable risks; it is expected that these premiums will be sufficient in the aggregate to pay all losses sustained by the risks in the group. To do so, the number of risks insured must be large enough for the law of averages to operate. However, insurance companies are often offered, or may be compelled to accept, insurance of a class for which they do not have enough volume in the aggregate to permit the law of averages to operate. Further, companies often write policies on risks for amounts beyond their financial capacities to absorb. Spreading of risks among insurance companies is called reinsurance (i.e., insurance for an insurance company). The company transferring the risk is called the ceding company, and the company to which the risk is transferred is called the assuming company, or the reinsurer.

Although a ceding company may transfer its risk to another company through reinsurance, it does not discharge its primary liability to its policyholders (absent the use of proper collateral provided by the reinsurer for the benefit of the ceding company). The ceding company remains liable for claims under the policy; however, through reinsurance, the ceding company reduces its maximum exposure in the event of loss by obtaining the right to reimbursement from the assuming company for the reinsured portion of the loss. The ceding company is also exposed to the possibility that the reinsurer will not be able to reimburse the ceding company. Fronting is an arrangement between two or more insurers whereby the fronting company issues a policy and then

cedes all or substantially all the risk through a reinsurance agreement to the other insurer(s) (the fronted company) in return for a ceding commission. As with other reinsurance contracts, the fronting company remains primarily liable on the insurance contract with the insureds. Fronting arrangements usually are initiated by fronted companies that are not authorized to write insurance in particular jurisdictions.

The term "captive" has been broadly applied to any insurance company with owners who are generally the same as, or related to, the parties whose risks comprise a substantial portion of those insured by the company. Generally, a captive insurance company operates at the behest of and for the benefit of a non-insurance parent company or group (e.g., "group captive"). Thus, a captive insurance company is one that is owned by those whose risks it insures. Ownership may be by a single parent or by a group of shareholders. From an organizational perspective, these entities resemble mutual insurance companies but for a limited number of participants. A significant component of the alternative risk market is represented by "captive" insurance companies. Due to their growth, strength, and utility over the past decade, captive insurance companies are no longer considered by many insurance professionals to be merely an "alternative" insurance market. In fact, the use of a captive is now seen as an integral part of general business risk management.

DEFINITION OF AN "INSURANCE COMPANY"

Section 816 (formerly § 801) of the Internal Revenue Code ("IRC" or "Code") defines a life insurance company, providing in part that "the term 'life insurance company' means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." IRC § 831, which relates to insurance companies "other than life insurance companies," states that the term "insurance company" has the meaning given to such term by section 816(a). See IRC § 831(c).

On the other hand, Treas. Reg § 1.801-3(a)(I) defines an insurance company as a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contacts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carryon, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

The IRS has not ruled on whether the more stringent "greater than half" test set forth in IRC § 816 applies to an insurance company other than a life insurance company, and there is case law on the "primary and predominant business activity" test (see the following paragraph). Nevertheless, because of the direct language of § 831(c), our assumption is that the "more than half" test applies to both life and non-life insurance companies on an annual basis. Several courts have addressed the issue of whether a company qualifies as an insurance company based on the company's primary and predominant business activity. The leading case is Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932).

WHAT CONSTITUTES "INSURANCE" AND AN "INSURANCE CONTRACT"

The principal test for what constitutes "insurance" is set out by in Helvering v. LeGierse, 312 U.S. 531 (1941). In that case the Supreme Court states that "[h]istorically and commonly insurance involves risk-shifting and riskdistribution." Further, the Court stated that "the risk must be an 'insurance risk' as opposed to an 'investment risk'." The court in Epmeier v. U.S., 199 F.2d 508, 509-10 (7th, Cir. 1952), defined an insurance contract as a "contract, whereby, for an adequate consideration, one party undertakes to indemnify another against loss from certain specified contingencies or perils."

Neither the IRC nor the regulations specifically define the term insurance contract. The courts have generally required that a transaction involve both risk shifting (from the insured's perspective) and risk distribution (from the insurer's perspective) in order to be characterized as insurance. See LeGierse; Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 411 (3rd, Cir. 1990).

Risk shifting occurs when a person facing the possibility of a loss transfers some or all of the financial consequences of the loss to the insurer. Rev. Rul. 88-72, 1988-2 C.B. 31, clarified

by Rev. Rul. 89-61, 1989-1 C.B. 75. The risk transferred pursuant to an insurance contract must be a risk of economic loss. Allied Fidelity Corp v. Commissioner, 66 T.C. 1068 (1976).

Risk distribution incorporates the statistical phenomenon known as "the law of large numbers." When additional statistically independent risk exposure units are insured, although the potential total losses increase, there is also an increase in the predictability of average loss. This increase in the predictability of the average loss decreases the amount of capital that an insurance company needs per risk unit to remain at a given solvency level. See Rev. Rul. 89-61, 1989-1 C.B. 75. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. While some court cases give support to meeting the test simply by having sufficient "unrelated risks ... in a pool for the law of large numbers to operate," the IRS focus appears to be on the number of policyholders involved in the transaction and also the number of policies (sometimes called "risk units.")

Further explanation of risk shifting and risk distribution is contained below in the section on Premium Deductibility Issues.

FOREIGN CAPTIVES

Led by Bermuda in the 1960s, foreign jurisdictions were the first to establish laws for captive insurance companies. In 1981, Vermont became the first U.S. state to offer captive insurance companies, and since then, many states have enacted captive insurance statutes. The captive operational costs in most foreign countries still continue to be less than found in the U.S. The majority of all captives are located in foreign jurisdictions, although hundreds of captives each year are formed in the U.S.

Many foreign captive insurance companies with U.S. shareholders make an election under Section 953(d) of the IRC to be taxed as a U.S. corporation for all purposes. For companies utilizing this election, there is no unique tax benefit to forming a captive in a foreign country. However, because of the lower regulatory burden and operational costs in many foreign countries, captive insurance companies continue to be formed in foreign jurisdictions in large numbers.

The election available under Section 953(d) of the Code is only available to an insurance company. If a foreign company fails to qualify as an insurance company, it cannot make a 953(d) election, and thus will be taxed under Subpart F of the Code. While this topic is beyond the scope of this Memorandum, in summary the effect of an invalid Section 953(d) election is to treat the entity as a controlled foreign corporation (CFC) as defined in IRC Section 957.

An important decision in establishing a captive insurance company is determining where it will be domiciled. As stated above, U.S. companies can form the captive onshore (located within the jurisdiction of the United States, or offshore (located outside the jurisdiction of the United States). The various alternatives have advantages and disadvantages for the owners. Four key areas a company should focus on when choosing a domicile for a captive are: (1) the regulatory environment, (2) the infrastructure of the country or state, (3) the tax consequences, and (4) the cost of maintaining the captive. This decision on the choice of domicile must be made on a case by case basis, and sometimes ongoing basis, for each captive.

One advantage many offshore locations have over U.S. domiciles is a flexible regulatory environment. For example, one of the most important regulations governing captives involves capitalization requirements, i.e., the amount of capital necessary to qualify as an insurance company.

Initial capitalization requirements vary widely, with some jurisdictions as low as $100,000, and others much higher. In recent years, states in the U.S. have become more competitive with the foreign domiciles, and have implemented more reasonable capital requirements.

831(B) INSURANCE COMPANY

Under IRC § 831(b), if an insurance company receives premium income of $1.2 million or less per year and files the appropriate tax election, the entire premium is exempt from tax. For a captive so qualifying, the business(es) paying the

premiums would receive a deduction of (up to) $1.2 million per year, and the captive insurance company would not be taxed on the receipt of that (up to) $1.2 million in premium. Importantly, this is not for the first $1.2 million, but only applies if the total premiums are $1.2 million or less in a given year. Section 831(b) companies pay tax on any net investment income at normal "C" corporation rates.

To gain status under IRC § 831(b) or § 501(c)(15) (discussed directly below), the captive's primary business ("more than half') must be the issuance of insurance contracts or the reinsurance of risks. Thus, each year, the premium income to the captive should exceed all other income to the captive.

In addition, the captive must meet the tests of risk shifting, risk distribution, and traditional notions of insurance. Section 83 I (b) insurance companies file federal tax return Form 1120-PC.

501(C)(15) INSURANCE COMPANY

Section 501(c)(15) of the tax code (last amended in 2004) permits a captive to qualify as a tax exempt company if the "gross receipts" of the company are $600,000 or less each year. "Gross receipts" is a technical term, but it includes insurance premiums and all investment income. In addition to this gross receipts limit, the annual premium income must exceed all other "receipts" to the insurance company (i.e., the "more than half' rule). Thus, the theoretical maximum investment "receipts" is $299,999 per year. For example, if the premium income was $250,000 in a given year, then other "receipts" could not exceed $249,999. However, premium income in theory could consume the entire $600,000 amount.

If a captive does not qualify for Section 501(c)(l5) status for a particular year, it may still qualify under Section 831(b). The qualification is done on an annual basis. When a captive is sold or liquidated, its owners will pay tax on gain in the value of their stock at long-term capital gains rates (currently 15% federal).

Section 501(c)(l5) captives will pay tax on any unrelated business taxable income (UBTI) generated by the insurance company. This UBTI rule applies to all tax-exempt entities (such as retirement plans) and not just section 501(c)(l5) insurance companies. UBTI means "the gross income derived by [the insurance company] from any unrelated trade or business regularly carried on by it."

While general "investing" is not considered an unrelated business, the operation of a typical business would be considered "unrelated" and therefore taxable. The UBTI rules are complex and beyond the scope of this Memorandum.

Section 501(c)(l5) insurance companies file federal tax return Form 990. Form 990 is the same form filed by other tax -exempt entities, and requires additional disclosure about affiliated entities. Clients desiring qualification under IRC § 501(c)(l5) generally file Form 1024 to apply for exemption recognition from the IRS. Form 1024 and related information (including information about the captive) is deemed to be information available for inspection by the public. Section 501(c)(l5) insurance companies were more popular prior to the 2004 change in law. Since that time, they have not been used frequently. The Form 990 disclosures require the captive's owner to disclose all sources of income, and this tax return is a publicly-available document. Also, it is often difficult to keep both premium and investment income under $600,000 per year. Furthermore, if a prior 501(c)(15) company becomes taxable, there may be additional taxes paid on gains within the captive.

Nevertheless, this code section is still part of the IRC, and so it is available.

CONTROLLED GROUP RULES

Captives qualifying under either IRC §§ 831(b) and 501(c)(l5) are subject to "controlled group" rules, found in IRC § 1563. While summarized below, these rules are complicated and are subject to various interpretations. We encourage you to seek advice if you are not clear as to how these rules apply to your situation.

A "parent-subsidiary" controlled group may exist if your captive is part of a chain of corporations connected through stock ownership with a common parent if (a) stock possessing at least 80% of the total voting power or the total value of all shares of stock of each corporation, except the parent, is owned by one or more of the other corporations, and (b) the

parent owns stock possessing at least 80% of the total voting power or the total value of all shares of stock of at least one of the other corporations.

A "brother-sister" controlled group may exist if your insurance company is one of a group of corporations where five (5) or fewer persons or entities owns stock possessing more than 50% of the total voting power or the total value of each corporation in the group, taking into account the stock ownership of each person only to the extent such stock ownership is identical with respect to each such corporation.

Because controlled group rules are based on stock ownership, we believe the rules do not extend to non-stock entities such as partnerships, trusts and limited liability companies; however, we have seen no definitive IRS ruling on this matter. In the IRS regulations (section 1.1563-I(b)(2)), subchapter "s" Corporations are listed as excluded members of controlled groups. This is logical as "s" Corporations do not pay corporate income taxes. If, however, a non-stock entity or "s" Corp is an ownership "link" in a chain of ownership between your insurance company and another "c" Corporation, the insurance company may still be a component member of a controlled group. Stock owned by the spouse or minor children (under age 21) of an individual who also owns stock in the same entity is usually attributed by the IRS to be owned by that individual. Ownership of stock by other close family members may also be attributed to an individual who owns more than 50% of the shares or voting power of an entity.

For an insurance company filing a Form 1120-PC tax return (§ 831(b) company) the combined premium income of all component members of the controlled group must not exceed $1,200,000. (For §831(b) companies, since the test only aggregates premium income, and not gross revenue of the businesses.) This combined premium would include all captives qualifying under § 831(b) that are part of the same controlled group. The same consolidation principles apply for purposes of meeting the gross receipts tests for IRC § 501(c)(15) captives.

CONSOLIDATED REPORTING COMPANIES

On September 27, 2007, the IRS issued proposed regulations under §1.1502-13(e), which apply to intercompany transactions involving the provision of insurance between members of a consolidated group. The proposed regulations provide that where a significant portion (defined as 5% or more) of the business of an insuring member arises from insuring the risks of other members, it is appropriate to take into account the items from the intercompany transactions on a single entity basis. This means that for members of a consolidated group, insurance paid to a captive (which is part of the consolidated group) will be treated in a manner comparable to "self insurance" by a single corporation.

These proposed regulations would have had the effect of eliminating the tax benefits associated with related party insurance transactions which have been provided for by the courts in a number of captive insurance cases, and which have been recognized by the IRS for many years. The IRS requested comments regarding this proposed regulation, and various captive associations indicated that they would challenge the regulation. The proposed regulation only applied to members of a consolidated group.

Where the captive is owned not by the same parent company, but owned by individuals or other entities that are not consolidated with the business, this regulation would not have applied.

The implications of the proposed regulation were rendered moot in February, 2008, when in a largely unprecedented move, the IRS retracted the proposed regulation altogether.

PREMIUM DEDUCTIBILITY ISSUES: BACKGROUND AND COURT-DEVELOPED LAW

The IRC does not establish clear rules for premium deductibility for payments to a captive insurance company. Under IRC § 162(a), a deduction is available for ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. Under the regulations, deductions for premiums paid to insure fire, storm, theft, accident or similar losses are authorized, On the other hand, money that is merely set aside to cover future contingencies is not deductible at the time the funds are reserved. Therefore, the deductibility of premiums paid to a captive depends on whether such payments are classified as premiums for insurance.

The term “insurance” is not defined in the IRC, nor is there any indication of the proper treatment of payments by parent corporations to captive insurance companies. Congress has left that very large “fill in the blank” problem to the courts and the IRS. Valid insurance premiums are deductible as an ordinary and necessary business expense under Reg. 1.162-1 (a). The regulatory classification of a corporation as an insurance company is generally irrelevant to its classification for U.S. tax purposes. As stated above, under IRC § 816(a), a company is an insurance company if more than half (>50%) of its business during the year is issuing insurance or annuity contracts or reinsuring risks underwritten by insurance companies.

Because captives are generally established and operated solely to provide insurance coverage, they rarely fail insurance company status due to the predominance of another business activity. For Section 501(c)(l5) companies, investment income and underwriting income must be closely monitored each year to ensure that the gross receipts tests are met.

The “more than half” test under the IRC is generally thought of as a strict numerical test, i.e.,” more than 50%” of the revenue derived from the issuance of insurance. However, the IRS may take into account all of the “facts and circumstances” and look at other factors, such as the amount of business space allocated to the activity, the net income derived from the activity, and how “active” are the investments of the captive.
Many years ago, the IRS argued that captive insurance premiums should not qualify for business tax deductions under what is called the “economic family argument,” i.e., premiums paid between members of the same economic family would be disqualified, because (according to the IRS at the time) there is no “risk shifting.” In 2001 the IRS has abandoned this argument in most circumstances. The IRS changed its position because it lost a succession of court cases on the issue.

For example, Humana, Inc. upheld the deductibility of premiums paid to a captive insurance company by its brother-sister corporations. The Humana court, and those following Humana, applied a narrower balance sheet approach instead of the IRS’ economic family theory. The court reasoned that the net worth of the separate balance sheets of each of the brother-sister corporations (which did not take into account the related captive insurance company) was increased by the proceeds from insurance issued by the related captive. Accordingly, it found that the risk of loss had been transferred by each of the brother-sister corporations.

Humana held, however, that premiums paid by the parent corporation to its directly owned captive insurance subsidiary were not deductible because the parent’s balance sheet included the results of the operations of its insurance subsidiaries, and consequently its net worth was not affected by its transactions with its wholly owned captive subsidiary. Therefore, Humana found a lack of risk shifting in the case of parent-subsidiary insurance. The holding of Humana was essentially that premium payments between “sister” companies were deductible, while premium payments from parent to child companies were not deductible. This holding was expanded in later cases to include premium payments to subsidiary corporations.

In another case, the deductibility of premium payments by a direct parent was allowed by the Claims Court in Ocean Drilling & Exploration Co. in which the Court of Claims applied a three-prong test that had been articulated by the Tax Court in cases such as AMERCO, Inc.

The three prongs of this test ask whether:

1. The arrangement involves the existence of an insurance risk.
2. There is both risk shifting and risk distribution.
3. The arrangement is for “insurance” in its commonly accepted sense.

In applying the AMERCO three-prong test, the courts looked to facts and circumstances, with certain facts having relevance for more than one prong of the test. The existence of an insurance risk depended on whether the transfer of the risk to the insurer and the exposure of the insurer were “real, not illusory.” Risk shifting depended on such facts as whether insurance contracts were written and premiums and claims paid, related-person premiums were negotiated at arm’s length, and the insurance company was a separate entity, regulated under the laws of its home jurisdiction, and

financially capable of meeting its obligations. Risk distribution was present if there was substantial unrelated business or the risks were diverse and multifaceted. Finally, relevant to whether insurance existed in its commonly accepted sense were such facts as whether the insurer was organized and operated as an insurance company, regulated by insurance law, and provided with adequate capitalization, and whether the premiums were negotiated at arm's length and valid and binding insurance policies were issued by the company.

Malone & Hyde Inc. involved facts similar to those in Humana in that Malone & Hyde created a captive subsidiary in Bermuda to provide insurance for it and its subsidiaries. It obtained a master policy from a domestic insurance provider who then entered into a reinsurance agreement with the captive. The Tax Court analyzed the facts in Malone & Hyde using a three-prong test, which examined whether the transaction involved (I) "insurance risk"; (2) risk shifting and risk distribution; and (3) "insurance" in its commonly accepted sense. The Tax Court, following the case law in the Sixth Circuit, applied the Humana net worth and balance sheet tests and looked at the impact a claim of loss would have on the insured subsidiaries' assets.

Under this criterion, the Tax Court held that the three-prong test was met and allowed the deduction. On appeal, the Sixth Circuit reversed, stating the tax court put the cart before the horse in this case in that it should have first determined whether the captive was a sham before it applied the three-prong test. The Sixth Circuit held that the insurance agreement in Malone & Hyde was a sham and distinguished it from Humana in that, unlike Humana, Malone & Hyde had no problem obtaining insurance; again, unlike Humana, the captive in Malone & Hyde was undercapitalized; and because of the undercapitalization, the reinsurance company required Malone & Hyde to sign a hold harmless agreement. By stating that a court should first determine if an insurance transaction is bona fide before it applies mechanical tests (i.e., the net worth or balance sheet tests) to determine whether risk shifting and risk distribution exist, the Sixth Circuit's decision in Malone & Hyde clarifies the Humana decision.

Another case that merits particular consideration is Kidde Industries, Inc. , which focuses on the brother-sister issue. Kidde was a broad-based, decentralized conglomerate with approximately 15 separate operating divisions and 100 wholly owned subsidiaries, each of which operated as its own profit center. In the midst of a products liability crisis in the mid-1970s, Kidde was unable to obtain insurance at reasonable rates. Because of the unavailability of a commercial products liability insurer, Kidde created a wholly-owned captive subsidiary incorporated ("KIC") and entered into a reinsurance agreement with a commercial insurance company that covered workmen's compensation, automobile, and general liability insurance, with KIC assuming the first $1 million of workmen's compensation, automobile, and general liability claims and the first $2.5 million of each products liability claim. Over the next two years, Kidde paid the commercial insurance company which ceded about 90% of these amounts to the captive for which IRS disallowed a deduction. The Court of Federal Claims began its deductibility analysis by testing whether the captive insurance arrangement was a sham, examining the capitalization and financial condition of the captive. It concluded that the arrangement was not a sham in that the commercial reinsurance company was willing to reinsure with the captive the claims on which it was primarily liable.

Next, the court tested whether the arrangement was consistent with commonly accepted notions of insurance. It determined that the premiums were generally established through means typically used in the insurance industry. Also, the interaction between claimants and the captive was essentially the same as occurred with other reinsurance companies. Here, the court concluded that the organization and operation of KIC was not inherently inconsistent with commonly accepted notions of insurance.

Finally, the court looked to the requirement set forth in LeGierse of risk shifting and risk distribution and applied them to amounts paid by Kidde's wholly-owned subsidiaries and then applied the same analysis to divisions within Kidde's corporate structure. It concluded that Kidde's subsidiaries were entitled to a deduction for the payments to the commercial insurance company for coverage ceded to the captive. In reaching this conclusion, the court applied the Moline Properties doctrine, which required treating Kidde and its wholly-owned subsidiaries as distinct from one another as well as from the Kidde shareholders. The captive

had assumed responsibility for future claims, which would involve shifting risk away from the subsidiaries in the same way that an arrangement with an independent third party insurer would. Risk distribution had occurred because the captive had pooled the risks of the subsidiaries.

Another challenge by the IRS in Kidde was aimed at the offshore incorporation of the insurance company. The company was organized and incorporated in Bermuda. The IRS advanced the argument that the organization and operation of the company was inconsistent with commonly accepted notions of insurance because of its incorporation in Bermuda, the control Kidde exercised over the company, and the comparatively small amount of traditional insurance functions the company performed. As to the offshore incorporation, the court noted that Bermuda has far less regulation of insurance companies than does the United States. As to the foregoing issue the Court concluded as follows:

"With respect to the incorporation in Bermuda, any corporation, including insurance corporations, generally can be expected to base its decision as to where to incorporate and where to locate ... on a determination as to which choices will result in maximum profits for the corporation. Hence, an insurance corporation's decision to incorporate in Bermuda because of a more favorable regulatory environment … would not be inherently inconsistent with commonly accepted notions of insurance. Indeed, courts … have allowed deductions for payments to captive insurers incorporated in Bermuda."

Thus, the Kidde decision supports "choice of jurisdiction" as a reason for forming a captive in a foreign jurisdiction.

COMMONLY-ACCEPTED NOTIONS OF INSURANCE

In determining whether the arrangement meets the "commonly accepted notions of insurance" Test, one must inquire about the manner in which the insured and the related insurer interact. With a captive insurer, all transactions between the parties should be undertaken, and documented, in the same manner as they would if the insurer were an unrelated commercial carrier; premiums should be set on an arm's-length basis and paid in cash in a timely manner; formal policies should be issued in a timely manner and with standard commercial terms; claims should be filed and paid on a timely basis, and handled in a normal commercial manner. Factors to be considered in determining whether a captive insurance transaction is insurance include whether (1) the parties that insured with the captive truly face hazards; (2) premiums charged by the captive are based on commercial rates; (3) the validity of claims was established before payments are made; and (4) the captive's business operations and assets are kept separate from the business operations and assets of its shareholders.

In meeting the "commonly accepted notions of insurance" standard, captive owners should carefully invest the captive's capital and reserves. Investment of the captive insurer's funds in the parent or another affiliate, whether in the form of loans or purchases of other securities of the parent, may lead to disqualification of the captive. We strongly advise all captive clients to avoid "circular cash flows" or loans from the captive to the insured or any other related party. If there are loans of this sort, they should be done on an arm's-length basis, be commercially reasonable in all respects, and be secured. Interest, as well as principal, should be paid on a current basis, as provided in the loan documents. In Notice 2005-49, the IRS identified loans to affiliates as a possible audit issue.

In addition, captives should not be undercapitalized or significantly overcapitalized, and should invest conservatively in a diversified portfolio of assets. As a general rule, a captive's investment should mirror the nature of investment of a conventional insurance company: no personal assets (e.g., vacation homes) should be owned by the captive.

One other reason to diversify the captive's assets is that the IRS has recently asked if the captive could exist if its largest investment failed. If the answer is no, then the IRS argues that the assets are not sufficiently diversified to be an insurance company. If a captive has concentrated assets, it is susceptible to this argument by the IRS.

Significant insight into the IRS view of "commonly accepted notions of insurance" can be gleaned from FSA 200202002, which was released on January 14, 2002. In that instance, the captive wrote an environmental impairment liability policy which was not initially available in the U.S.

commercial market, but the captive never retained an actuary to either assess its liability or establish the appropriate premium. A commercial carrier did offer the policy in the U.S. in year two, apparently at a significantly lower premium than that charged to the taxpayer by its captive; after the end of year two, the captive retroactively reduced the premium charged to the taxpayer under the environmental impairment policy, added coverage for four additional related insureds, and added blanket wrap-up liability coverage listing seven independent contractors as insureds, without notifying them. The net effect was to leave premiums received by the captive essentially the same, but to reallocate it to different insureds. The bulk of the insurance premiums received by the captive were paid late, and by the end of year two the captive had invested approximately 97.5% of its gross assets with affiliates. In light of these facts, the IRS National Office took the position that the arrangement did not constitute insurance in the generally accepted sense. With respect to the investment of the captive's funds with affiliates, the National Office, in a clear understatement, noted that the commercial market generally does not allow an insurer to invest substantially all of its assets in affiliates.

The National Office position in PSA 200202002 regarding investment of the captive's funds in affiliates should be contrasted with its position in FSA 199945009, in which a captive loaned a portion of its funds to a related finance company, which re-loaned funds within the group. In that instance, the National Office advised agents to review the loans by the captive to see if arm's-length interest had been charged, and to determine whether the arrangement should be attacked due to the circular flow of funds. By focusing on the level of investments in affiliates by the captive and comparing it to the level of affiliate investment by a commercial insurer, rather than focusing on the arm's-length nature of the captive's investments, the National Office in FSA 200202002 clearly raised the bar for captive insurers and their owners. In those instances in which a portion of the funds will be invested with affiliates, captives and their owners would be well advised to ensure that all formalities are followed in all other aspects of the transaction, in order to limit any challenge to the captive. Ideally, investments with affiliates should be minimized, and "circular" cash flows (i.e., borrowing back out the premium) should be avoided.

In 2007, the IRS issued Revenue Ruling 2007-47, which holds that one cannot insure against a known future cost, even if the exact amount and timing of the future costs is a function of many factors. The IRS relied heavily on the notion that from an insurance standpoint, there is no risk unless there is uncertainty, or, to use another term, fortuitousness, of the potential loss. Where the fact of the future loss was certain (in this case, the future cleanup of a nuclear power plant), the future losses did not give rise to an insurance contract, even thought the timing and amount of the future losses were unknown. This ruling is hotly debated by insurance experts, and is probably not the last word on this subject of "fortuitousness

BUSINESS PURPOSE

In Hospital Corporation of America v. Commissioner, ("HCA "), the Tax Court held that insurance premiums paid to a sister corporation were deductible under the holding of Humana. HCA features several novel factual aspects which gave the court an opportunity to add to the body of law governing the deductibility of insurance premiums paid to a captive insurer. In addition, the decision reestablished the importance of Humana, which had arguably been narrowed by the Sixth Circuit's 1995 decision in Malone & Hyde. Finally, the decision reflected a continuing trend to analyze captive insurance cases in terms of whether the arrangement was a sham. In HCA, the taxpayer, the common parent of an affiliated group of corporations that owned, operated and managed hospitals, formed a captive insurance company to insure the general and professional liability and workers compensation risks of HCA and its subsidiaries. The captive was adequately capitalized and, by the end of its first year of operation, had hired its own management and staff. Because appeal in the case lay in the Sixth Circuit, the Tax Court in HCA relied on the Sixth Circuit's decisions in Humana and Malone & Hyde.

The Tax Court in HCA viewed the issues in the case to be (i) whether the relationship between the taxpayer and the captive consist of "bona fide" insurance transactions, and whether the taxpayer's risks shifted to the captive. The IRS pointed to several facts that tended to show that the transactions at issue were not "bona fide" insurance transactions, including a "comfort letter" and indemnification agreement

provided by the parent for the benefit of the captive. The comfort letter and indemnification agreement pertained only to direct workers' compensation risks and only for specified periods. The comfort letter and indemnity did not pertain to the other lines of business. The court acknowledged the similarity between these guarantees of the captive's performance and the hold harmless agreement that caused the Sixth Circuit to hold in the IRS' favor in Malone & Hyde. However, the court, relying on a sham analysis rather than addressing the issue of whether insurance was present for tax purposes, held that the comfort letter and indemnity did not negate the existence of insurance because worker's compensation risks did not constitute the captive's primary line of business. The court agreed that the facts relied upon by the IRS were "factors to consider" but were not conclusive.

The court likewise rejected the IRS' argument that HCA was distinguishable from Humana because the captive in Humana filed a separate return from Humana and the sister subsidiaries, while in HCA the captive filed its return on a consolidated basis with HCA and the sister corporations. According to the court, a consolidated tax return treats members of the affiliated group as a single entity for some purposes and as separate entities for other purposes. The court stated that the consolidated return regulations calculate income of each corporation in an affiliated group separately as a threshold matter, and in that respect the tax treatment of insurance premiums is reflected on a separate basis. Accordingly, the court concluded that the inclusion of the captive on HCA's consolidated return did not render the transaction a sham. Although the court in HCA clearly considered it important that HCA had a business purpose in forming the captive, the court did not require that HCA be unable to purchase insurance elsewhere at any price; it merely required that the use of the captive insurer reduced RCA's risk management costs. The decision in Malone & Hyde had implied, and the IRS had taken the position, that anything less than impossibility of obtaining commercial insurance would not justify the formation of a captive. Thus, HCA stands for the proposition that reducing insurance costs is a valid business purpose.

The non-tax-related business purpose of forming an association captive illustrated in Rev. Rul. 2002-91 is selfevident. The industry insured by the captive is required by regulators to maintain adequate liability insurance coverage to operate, and, due to the occurrence of unusually severe loss events, affordable insurance coverage for businesses in that industry is not available from commercial insurance companies.

A somewhat similar, though less compelling, business purpose is evident in TAM 200323026: the desire for pollution liability coverage and (although not stated in the TAM) the lack of affordable coverage from third-party insurers. Thus, the IRS does not cite the lack of business purpose as a factor in finding that the arrangement in the TAM does not constitute insurance. Frequently, however, the primary purpose for choosing to retain risks within a group of related or unrelated companies is the opportunity to earn the profit that an unrelated insurance company would have earned and to save the selling and administrative costs that would have been incurred by a wholly unrelated insurance company. In a pure parent-subsidiary or single brother-sister captive arrangement, it would be difficult to discern a non-tax business purpose for forming a low-taxed captive as opposed to the parent or the brother merely self insuring its own risks. As soon as a group is formed or third-party risks are insured however, the advantage of pooling ones risks and the premiums with those of third parties or of other members of the group or third parties can give rise to a business purpose.

In such circumstances, the presence of adequate capital and surplus is considered necessary to ensure that risk has shifted to the captive and that the taxpayer is not merely self-insuring its risks. A lack of concentration of risk is necessary to ensure that the advantage of premium pooling and risk distribution is sufficiently present, again to distinguish the arrangement from self-insurance, without a shifting of risk and risk distribution; there is no insurance, and thus no non-tax business purpose for entering into a captive insurance arrangement. That is exactly what was found in Malone & Hyde. In that case, the reinsurance captive was inadequately capitalized, and the parent had to enter into a "hold harmless" agreement with the direct insurer. As a consequence, the Sixth Circuit found that the taxpayer "without any legitimate reason, devised the circuitous scheme for realizing tax deductions."

However, the IRS suffered a serious blow in United Parcel Service of America, Inc ("UPS").

The Tax Court and the dissent in the Eleventh Circuit similarly found that the creation of the insurance subsidiary, its spin off to shareholders, and the diverting of premiums to it was a sham lacking business purpose.

Before a reversal by the Eleventh Circuit, the Tax Court's memorandum decision in UPS caused concern in the insurance industry. UPS had enjoyed a lucrative profit from its excess value charges (shipping insurance) paid by customers for many years and had diligently tracked these shipments so that loss claims were relatively low. After discussions with tax advisors, UPS forwarded the excess value charges (net, after claims) to an independent insurer (National Fire Insurance Company). UPS continued to handle and process the claims on behalf of the insurer. National forwarded the net funds that it received, less a commission, to a Bermuda captive, Overseas Partners Limited (OPL).

Shares of the captive were distributed to UPS owners as a taxable dividend. The Tax Court concluded that since UPS performed basically the same services after the captive was formed as it did before, and the captive's formation lacked economic substance, the transaction was a sham and UPS had essentially assigned its income. (While there were potential insurance law violations that could have necessitated organizational changes, the captive formation did not solve those problems.)

The appellate court disagreed, noting that there was a bona fide insurance policy with National. While shipping charge collections had been historically lucrative, there was no indication that the trend would continue and OPL was now an independent taxable entity not under UPS control. The Eleventh Circuit observed that UPS had an adequate business purpose to neutralize any tax avoidance purpose and went on to refine the business purpose doctrine, stating that "business purpose" does not mean "a transaction free of tax considerations," but rather entails a bona fide profit-seeking entity that is a going concern that seeks to alter the form of a business, even if it is for tax purposes.

Some of the facts in UPS are quite interesting: no insurance license, no bona fide structure, restructuring of excess value charges, etc. UPS failed to operate the insurance company as a separate entity and used it merely as a depository for funds remitted. UPS did not even obtain an insurance license from Bermuda, the jurisdiction in which they were organized. Moreover, they did not pay claims from the insurance company reserves, and the checks were cut from UPS corporate account. Notwithstanding all of these "defects," the court ruled that the insurance arrangement was valid and that UPS could take a deduction for the insurance policies paid to its captive insurer. Some language from the case is helpful:

> "There was a real insurance policy between UPS and National Union that gave National Union the right to receive the excess-value charges that UPS collected. And even if the odds of losing money on the policy were slim, National Union had assumed liability for the losses of UPS's excess value shippers, again a genuine obligation. A history of not losing money on a policy is no guarantee of such a future. Insurance companies indeed do not make a habit of issuing policies whose premiums do not exceed the claims anticipated, but that fact does not imply that insurance companies do not bear risk. Nor did the reinsurance treaty with OPL, while certainly reducing the odds of loss, completely foreclose the risk of loss because reinsurance treaties, like all agreements, are susceptible to default."

> "A 'business purpose' does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a 'business purpose: when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business .... This concept of 'business purpose' is a necessary corollary to the venerable axiom that tax-planning is permissible. See Gregory v. Helvering, 293 U.S. 465, 469, 55 S.Ct. 266, 26, 79 L.Ed. 596 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."). The Code treats lots of categories of economically similar behavior differently. For instance, two ways to infuse capital into a corporation, borrowing and sale of equity, have different tax consequences; interest is usually deductible and distributions to equity holders are not. There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the

> taxpayer lacks a 'business purpose.' To conclude otherwise would prohibit tax-planning."

UPS is certainly an important case that stands for the proposition that tax savings is a valid motivation for corporate planning.

ADEQUATE CAPITALIZATION

As illustrated by TAM 200323026 and Malone & Hyde, a lack of adequate capital is typically determinative in finding that a captive insurance arrangement does not constitute insurance for tax purposes. Although the existence of a parent or related-party guarantee is frequently cited as a separate factor indicating the captive was not a bona fide insurance company, it is difficult to understand why the presence of such a guarantee should prejudice the finding of bona fide insurance if the captive is adequately capitalized. Therefore, it may be that the presence of a related-party guarantee is problematical only insofar as it is normally required only when a captive's capital and surplus is potentially inadequate for the risks it has insured, as in Malone & Hyde and TAM 200323026.

It is not uncommon for the parent of an insurance group to provide some form of financial support, such as backing a letter of credit, to meet regulatory requirements of a new insurance subsidiary or to enhance the ability of a subsidiary to write insurance. It is arguably not inconsistent with an arm's length insurance arrangement, or for risk shifting in the brother-sister context, for the parent to issue such a guarantee or other financial support. Moreover, where a captive is undercapitalized and the guarantor is a parent or related company, an argument can be made that the insured subsidiary has been indemnified for its risks. Nevertheless, once the absence of insurance characterization of the premiums has been found, there appears to be a reluctance, as in TAM 200323026, to consider that the payments otherwise should be deductible.

At the other extreme, too much capital relative to risks assumed may indicate that the business of the captive is that of an investment company and not an insurance company, as were the captives described in Notice 2003-34 and as suggested in Notice 2002-70.

Thus, the IRS has attempted to argue that some captives should be invalid because they have too little capital, and others should be invalid because they have too much capital. Certainly, having the capital and surplus required by the jurisdiction issuing the insurance license would be the minimum necessary-and perhaps sufficient amount of capital. Clients should always at least meet the statutory requirement for capital. For foreign jurisdictions, the minimum is usually $100,000.

One recent attack point by the IRS has been to ask if the captive has sufficient liquidity to pay its largest single potential claim. If the largest potential claim (i.e., policy limit) is $1 million, and the captive has less than $1 million in liquid capital, this allows the IRS to argue that if the captive can't even pay its largest single potential claim, it isn't an insurance company. Thus, maintaining adequate liquidity in the captive is an important consideration. In many instances, additional paid-in capital is required to achieve a sufficient level of liquid capital.

ARM'S-LENGTH AND COMMERCIAL DEALING

Although the lack of arm's-length terms in a captive insurance arrangement is sometimes cited as a factor in determining whether the arrangement constitutes insurance for federal income tax purposes, the applicability of IRC §§ 482 and 845 ordinarily should result in only an allocation or recharacterization of income and deductions among the parties to reflect clearly their income or to reflect the proper source and character of the income, as suggested by the UPS court.

Nevertheless, if the allocation or recharacterization of income and deductions were of a sufficient magnitude, it potentially could result in a captive being found not to be an insurance company for tax purposes, because, for example, it was overcapitalized for its insurance business and/or not predominantly engaged in the business of insurance

Whether amounts in an insurance arrangement reflect arm's-length amounts is indicative, however, of whether the insurance arrangement resembles commercial insurance arrangements and thus insurance in its commonly accepted sense, one of the three prongs of the test for insurance

set forth in such cases as AMERCO and Ocean Drilling & Exploration. Other commercial terms that frequently have been cited as indicative of a bona fide insurance arrangement include:

- The timely payment of premiums;
- Actual claims review and adjustment;
- The lack of rebating of premiums or retroactive charging of additional premiums based on loss experience; and
- Investment of capital and reserves in a diversified, high-quality portfolio of investments instead of being loaned back to the captive's parent or affiliates.

UNDERWRITING

Underwriting refers to the process that an insurer uses to delineate a specified risk, measure the risk exposure and determine the premium with which to insure such identified risk. The underwriting process culminates in the issuance of an insurance policy documenting the transfer or shifting of the risk. Since the underwriting process involves the identification of risk and the transfer of risk, two very important components of the test of what constitutes insurance, it is important to follow "commonly accepted notions of insurance" throughout the underwriting process.

The underwriting process begins on a preliminary basis during the captive feasibility study, where insurance professionals explore the potential insured the coverage needs, current insurance coverage shortfalls, gaps or exclusions, present and future exposures, and claims history of such potential insured. In the event that a feasibility study determines that alternative risk planning generally is appropriate, and more specifically captive insurance planning is desirable, the underwriting process further analyzes the insurable risks identified by the prospective insured and the compiled data to help further define and measure such risk. The compilation of data continues with the gathering of financial information, tax returns, existing insurance policies, claims histories, company brochures, and the examination of key relationship and interviews of key company personnel to bring into sharper focus the risk profile of proposed insured. The underwriting file is updated periodically and held for ongoing review by the captive manager.

Corprotect, LLC will send an underwriting application to its clients on an annual basis. Annually, the client must complete an underwriting application for each insured, which will help us in underwriting insurance policies for the captive.

We will prepare most of our policies using forms available to us by Insurance Services Offices, Inc. (ISO). Since 1971, ISO (see www.iso.com) has been the premier source of information regarding property and liability risk. ISO's statistical, actuarial, and underwriting information is a vital resource to insurers, government regulators, and other companies and organizations. Additionally, ISO's standardized policy language is the foundation on which many insurers build their coverage programs.

ISO offers an enormous database of insurance statistics. Each year, insurance companies report information to ISO on hundreds of millions of individual policies. At anyone time, ISO's computers store some 10.6 billion detailed records of premiums and losses. ISO has a staff of more than 200 actuaries including more than 50 fellows and associates of the Casualty Actuarial Society (CAS).

In addition to the policy forms provided by ISO, we may also prepare insurance policies for a captive that would be termed "excess risk," "specialty risk" and/or "surplus lines" policies. There is no corresponding database regarding the pricing or form language for these types of policies. Accordingly, these policies tend to be priced on a negotiated basis. If requested by clients (and for a separate fee) we can obtain an independent actuarial analysis of these policies (this type of data is generally not available in the market). Ultimately, the specific policies and amount of premiums paid for negotiated policies will be a decision made between the captive owner and each insured, and not by Synergy Captive Strategies, LLC.

INVESTMENTS

The topic of investments is beyond the scope of this Memorandum. Generally, however, clients should seek to have a diversified portfolio of investments inside the captive. A high percentage of the investments should be liquid. We encourage all captive owners to have competent financial

professionals to assist them in managing the assets of the captive, and to diversify the captive's investments.

RECENT GUIDANCE

The IRS and the courts continue to develop the application of the federal income tax law to insurance companies. The recent Revenue Rulings, Revenue Procedures, Internal Revenue Bulletin and Notices are as follows:

- Revenue Ruling 2001-31
- Notice 2002-70
- Revenue Procedure 2002-75
- Revenue Ruling 2002-89
- Revenue Ruling 2002-90
- Revenue Ruling 2002-91
- Notice 2003-34
- Notice 2003-35
- Revenue Ruling 2005-40
- Notice 2005-49
- IRS Notice 2006-42
- PLR 200714015
- PLR 200724040
- Revenue Ruling 2007 -4 7

Revenue Ruling 2001-31, issued June 4, 2001: With this landmark ruling, the Internal Revenue Service had acknowledged that it will no longer invoke and follow the "economic family theory" with respect to captive insurance transactions. The judicially accepted definition of insurance involves the following elements of risk:

- Risk-shifting the transferring of the financial consequences of the potential loss to the insurer.
- Risk-distribution-allowing the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim.

The sharing and distribution of the insurance risk by all the parties insured is essential to the concept of true insurance. The "economic family theory" argues that where insurance risk has not been shifted or distributed outside the "economic family" there cannot be valid or bona-fide insurance contracts. Valid and bona-fide insurance contracts are essential in obtaining deductions for premiums paid to a related party insurer.

As an alternative to the "economic family theory," the courts have historically employed a balance sheet test to determine if bona-fide insurance exists. Thus, where the risk of loss has been removed from the insured's balance sheet shift of risk has occurred.

Although the IRS has indicated that it will no longer invoke the economic family theory as an argument that risk has not shifted between related partied, the Service has indicated that it will continue to scrutinize each entity involved in an insurance transaction on many levels to determine if bon-fide insurance contracts exist.

These areas may include:

- Amount of capitalization of the insurance company.
- Ability of the insurance company to pay claims.
- Adequacy of corporate governance and formalities of the insurance company.
- Financial performance of the insurance company.
- Separate financial reporting for the insurance company.

Notice 2002-70, issued November 4, 2002: This notice dealt broadly with the type of entity known as a Producer-Owned Reinsurance Company or "PORC." The transaction outlined within the notice was (temporarily) labeled a "listed transaction" by the IRS. Listed transactions require additional reporting and record keeping requirement and may involve significant penalties if the ruled are not followed.

The transaction in the Notice involves a taxpayer that offers its customers the opportunity to purchase an insurance contract through the taxpayer in connection with the products or services being sold. The insurance provided coverage for repair or replacement costs if the product broke down or is lost, stolen, or damaged, or coverage for the customer's payment obligations in case the customer dies, or becomes disabled or unemployed. The taxpayer offers the insurance to its customers by acting as an insurance agent for an unrelated insurance company. Taxpayer typically receives a commission on the sale of the insurance policy. Taxpayer then forms a company in a foreign jurisdiction and reinsures

the policies sold for the unrelated insurance company. The foreign company elects to be treated as a domestic United States taxpayer.

As stated above, the facts of Notice 2002-70 were very broad and the analysis very general, leading to ambiguities and uncertainties. This was particularly worrisome insofar as the Notice applies to any transactions that are the same as, or substantially similar to, the transactions described therein. Due to a lack of analysis of how the law applies to the facts presented in the Notice, it is difficult to determine the IRS' opinion of the significance of the fact that the reinsurance company was a wholly owned subsidiary of the producer, and the impact of that fact on the Services determination of the arrangements' potential for abuse. Indeed, it is difficult to determine what other sets of arrangements would be treated the same as or substantially similar to the arrangements in Notice 2002-70.

However, in 2004, the IRS essentially "revoked" the PORC Notice, in Notice 2004-65. In this Notice, a Treasury Department news release said PORCs generally involve a U.S. domestic business, typically a service provider, automobile dealer, lender, or retailer, that offers its customers the opportunity to buy insurance on its products (car warranties being the chief among them). Premiums from the insurance contracts then are funneled from a domestic company set up by the taxpayer to a foreign shell company under a reinsurance arrangement, and substantial benefits are claimed for the income. In the Notice, the Treasury and IRS concluded that the transactions no longer should be identified as listed transactions after a review of the arrangements found fewer abuses than anticipated.

Revenue Procedure 2002·75, issued December 11, 2002: This revenue procedure discussed certain insurance transactions whereby the IRS will now contemplate issuing private letter rulings regarding whether a valid and bona-fide insurance arrangement exists between related parties.

The IRS had indicated that taxpayer's seeking a ruling should contact the appropriate department at the IRS to determine whether the fact in each case will be considered by the IRS for a ruling before preparing the ruling request. It is generally accepted that the IRS will not issue a private letter ruling where the facts differ substantially from its trilogy of revenue rulings (Rev Rul 2002-89, 2002-90, 2002-91), which are discussed below.

TRILOGY OF SAFE HARBOR REVENUE RULINGS

The following three revenue rulings provide three IRS "safe harbors" in captive insurance arrangements. It is our view that any captive arrangement ought to be structured so that it qualifies with one of these safe harbor arrangements, to provide maximum safety and protection to the captive from a tax standpoint. While more liberal arrangements may be considered "insurance" by the courts and future rulings, by working within a safe harbor, the captive has assurance from the IRS that its captive insurance program falls under IRS guidelines. This provides, in our view, a high degree of security to the captive and its insureds. These three rulings are discussed below.

(1) Revenue Ruling 2002·89, issued December 11, 2002: This ruling discussed two scenarios involving the payment of premiums by parent to its two wholly-owned captive subsidiaries. In the first scenario, the premiums paid by the parent to its wholly owned subsidiary accounted for 90% of the subsidiary's income for the year. In the second scenario, the premiums paid accounted for 50% of the second subsidiary's income for the year. In determining whether these scenarios represented valid insurance arrangement, the IRS noted that:

- Both insurance captives were adequately capitalized.
- Both insurance captives were properly regulated.
- The companies transacted their insurance business in a manner consistent with the standards
- applicable to an insurance arrangement between unrelated parties.

The IRS again focused on the concepts of adequate risk shifting and risk distribution and concluded that the arrangement in scenario one did not provide sufficient risk shifting or risk distribution while the facts in scenario two resulted in adequate risk shifting and distribution.

Thus, where over 50% of the subsidiaries' risk is with unrelated third parties, the IRS had concluded that sufficient risk shifting and risk distribution existed, resulting in a

bona·fide insurance arrangement. The IRS did not address circumstances between 10% and 50%, mindful of the well-known Harper case in the 9th Circuit which holds that 29% third-party insurance is sufficient for risk distributing purposes (under the particular facts of that case). As with any IRS pronouncement, it is the IRS' view on the subject matter; Congress or the courts actually decide what the law actually is. From the IRS' perspective, if less than 50% of the premiums and risk to the captive is paid by affiliates, this is considered a "safe harbor." However, the courts that have actually reviewed the matter have been more liberal. In addition, the fact pattern in Rev. Rul. 2002-89 differs from that in Harper in that the facts in the ruling deal with premiums paid from a parent corporation to its captive subsidiary, whereas the Harper decision involved brother/sister corporations paying premiums to their captive sister corporation.

There seems to be stronger theoretical basis for allowing deductions between brother/sister corporations than parent/subsidiary corporations. It is important to note that the majority view of the captive insurance community is that 30% third-party business is sufficient for risk distribution purposes. It is our opinion and business approach that a captive insurance company should arrange for unrelated sufficient unrelated insurance so that it qualifies under this safe harbor (or another safe harbor discussed below). The IRS retains the right to challenge arrangements where the captive has between 30% and 50% third-party business, notwithstanding some court cases that may have approved specific arrangements within these parameters.

(2) Revenue Ruling 2002-90, issued December 11, 2002: The IRS concluded that the premiums paid by 12 operating subsidiaries to a captive insurance subsidiary owned by a common parent deductible. The facts in Revenue Ruling 2002-90 are similar to the brother-sister subsidiary arrangement as outlined in the 5th Circuit's ruling in Humana. The IRS concluded that the transaction contained adequate risk shifting and risk distribution and that the amounts paid for insurance by domestic operation subsidiaries to an insurance subsidiary of a common parent are deductible as "insurance premiums." The IRS also made their position on several facts as follows:

- The insurance subsidiary was formed for valid and bona-fide non-tax reasons.
- There were no guarantees made by the parent or third parties in favor of the insurance subsidiary.
- No inter-company loans existed between the insurance companies, its parent or its sister subsidiaries.
- The premiums of the operating subsidiaries were determined at arms-length.
- The premiums were pooled such that a loss by one operating subsidiary is borne, in substantial part, by
- the premiums paid by others.
- None of the subsidiaries was insured for less that 5% or more than 15% of the total insured risk.

It is important to note the IRS analyzed each of the subsidiaries to ascertain:

- If they conducted themselves in all respects as would unrelated parties to a traditional relationship;
- Whether the insurance company is regulated as an insurance company in the jurisdiction(s) where it
- does business;
- Whether an adequate amount of capital was present within the insurance company;
- If the insurance company was able to pay claims;
- The adequacy of the insurance company's financial performance; and
- If separate financial reporting was maintained on behalf of the insurance company.

(3) Revenue Ruling 2002-91, issued December 11, 2002: The IRS concluded that a group captive arrangement, with each insured having no more than 15% of the total risk, was a bona-fide insurance arrangement. The ruling also outlines other factors that the IRS will consider in determining whether a transaction constitutes a bona-fide insurance arrangement. These factors include:

- Whether the inured parties truly face hazards.
- Whether premiums charged by the captive are based on commercial rates.
- Whether the risks are shifted and distributed to the insurance company, since the entities are

- commercially and economically related.
- Whether the policies contain provisions such that the covered risks may exceed the amount of
- premiums charged and paid.
- Whether the validity of claims is established before payments are made.
- Whether the captive's business operation and assets are kept separate from the business operation and
- assets of its shareholders.

The IRS again focused on risk shifting and risk distribution in determining whether the transactions are considered deductible "insurance premiums." This ruling looks favorably on a group captive whose business is restricted to insuring the genuinely insurable risk and then validating the subsequent claims of a reasonably small number of unrelated businesses in a highly concentrated industry. While only providing coverage to group members, the captive's assets and operations are separated from that of the members; all premiums, established using a commercial rate structure, are pooled and held by the captive in a general fund; and ownership, control expressed in term of board composition, and the risk insured through the captive does not exceed 15% of any total for a single captive. In addition, while losses might be expected to exceed premiums remitted to the captive, refunds are not given to members when losses are less than premiums. Here, the substance of the structure as well as transactions support the latter being "insurance" and therefore premiums are deductible.

Notice 2003.34, issued June 9, 2003: Notice 2003-34 involves the use of offshore insurance companies organized for the purpose of sheltering passive investment income derived from hedge found investments. Because of this Notice, our recommendation is that captives do not invest in offshore hedge funds.

The key concern in this Notice seems to be companies whose primary business is investments, not insurance. This notice should also be read in light of the law in existence at the time for Section 501(c)(l5) companies, which law was changed effective January 1, 2004. The foreign corporation's insurance activities are generally small compared to its investment activities.

The foreign corporation invests its capital and the amounts it receives as consideration for its insurance contracts in hedge funds or hedge fund type investments. As a result, the foreign corporation's investment returns substantially exceed the needs of its insurance business. The foreign corporation does not generally distribute its earnings to its shareholder. The shareholder of the offshore insurance company then disposes of the stock in a transaction that qualifies for capital gain treatment.

In addition, the IRS has indicated that it will scrutinize companies in this type of arrangement even if the company claims the exemption from tax pursuant to an existing determination letter or on a return filed with the Service. The lRS in this notice has indicated that it intends to attack these types of transactions in one of the following three ways:

- Definition of Insurance: The Service may argue that the insurance written by the insurance company does not meet the judicially established definition for insurance. This is the traditional attack based on the premise that bona-fide insurance contracts must shift and distribute risk from the insured to the insurer and that the insurer must distribute the risk amongst potential claimant. Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the law of large numbers to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. Pursuant to the decision in Humana, risk distribution necessarily entails pooling of premiums, so that a potential insured is not in significant part paying for its own risks.

- Status as Insurance Company: This method of challenge relies upon the premise that a taxpayer taxed as an insurance company must use its capital and efforts primarily in earning income from the issuance of insurance contracts. The income tax regulations provide that

a company will qualify as and insurance company only if more than half of its business is the issuing of insurance or annuity contract or the reinsuring of risks underwritten by insurance companies. Thus, the IRS in asserting this challenge will like to all of the relevant facts and circumstances for making the determination for whether an entity qualifies as an insurance company. Items taken into consideration in this assessment may include the size and activities of the insurance company's staff, whether it engages in other trades or businesses, and its sources of income.

- In utilizing this method of attack, the IRS specifically provides that "even if the contracts qualify as insurance contract, the character of all of the business actually done by the foreign corporation may indicate that the foreign corporation uses its capital and efforts primarily in investing rather than primarily in the insurance business."

- Possible Tax Treatment of Stockholder's interest in Foreign Corporation: In this method of challenge the Service will look for ways to categorize the income earned by the foreign corporation as passive investment income subject to U.S. income tax. This method depends upon the Service's ability to show that the foreign corporation is not involved in the active conduct of an insurance business. The rules for passive foreign investment companies impose current U.S. taxation on U.S. person that earn passive income through a foreign corporation. A foreign corporation is a passive foreign investment company if (a) 75 percent or more of the gross income of such corporation for the taxable year is passive income, or (b) the average percentage of assets held by such corporation during the taxable year that produce passive income or which are held for the production of passive income is at least 50 percent. Passive income is generally defined for the purpose of this test as dividends, interest, royalties, rents, immunities, and gains from the sake or exchange of property giving rise to this type of income.

- In the Notice, the IRS acknowledges that the business of insurance necessarily includes substantial investment activities. In addition, the Service states that the presence of investment earnings "does not, in itself, suggest that an entity does not qualify as and insurance company." Thus, the test for avoiding attack by the IRS under the options listed above depends on the presence of a predominant insurance activity within the foreign corporation.

Notice 2003-35, issued June 9, 2003: Notice 2003-35 deals specifically with IRC § 501(c)(l5). The notice serves to remind taxpayers that in order to qualify for tax-exempt treatment, the corporation must first qualify as an insurance company. Notice 2003-34 is cited as containing guidelines regarding what constitutes an insurance company. Those guidelines include:

- The issuance of insurance contracts or reinsurance of risks underwritten by insurance companies as the requirement that the primary and predominant activity of the insurance company must be that of insurance. For this purpose, the Service provides that more than half of the business activity of the company must be in the business of issuing insurance or annuity contracts or reinsuring the risks of policies underwritten by insurance companies.
- Insurance companies must have adequate risk shifting and risk distribution.
- The relationship between premium income and investment income.
- Other factors for consideration include the size and activities of the insurance company's staff, whether it engages in other trades or businesses, and its source of income.

This Notice may take on less importance given that the law regarding IRC § 501(c)(15) was amended in 2004.

Revenue Ruling 2005-40, issued June 17, 2005: This ruling reminds taxpayers that the requirement of risk distribution must be met for the arrangements to qualify as insurance. The ruling concludes that an arrangement with an entity that that insures the risk of only one policyholder does not qualify as insurance for tax purposes because the risks are not distributed among other policy holders.

For example, if "Ins Co" enters into an insurance arrangement with "X," and this is Ins Co's only such agreement, though the arrangement may shift the risks of X to Ins Co, those risks are not, in turn, distributed among other insureds or policyholders. Therefore, this arrangement does not constitute insurance for federal income tax purposes.

According to the IRS, such coverage does not spread risk among more than one policyholder and hence is not a bona fide insurance transaction. In this case policyholders are simply insuring themselves.

In other words, the transaction might be considered a deposit, a loan, a contribution to capital, or a non insurance indemnity arrangement - none of which are tax-deductible - but it wouldn't be considered insurance.

The ruling does state that risk distribution can be met by using multiple operating subsidiaries of the same company (parent/sub insurance) as long as those subsidiaries are independent entities (and not simply "disregarded" partnerships). Generally, an independent entity files a separate tax return. In the case of an LLC, it would need to have more than one member to be an independent entity.

IRS Notice 2005-49, issued July 5, 2005: This notice requests comments on additional guidance concerning the standards for determining whether an arrangement constitutes insurance for federal income tax purposes. The Notice further states that the Service and the Treasury Department are aware that further guidance is needed in this area and requests comments regarding: (i) the factors to be taken into account in determining whether a cell captive arrangement constitutes insurance and, if so, the mechanics of any applicable federal tax elections; (ii) circumstances under which the qualification of an arrangement between related parties as insurance may be affected by a loan back of amounts paid as "premiums;" (iii) the relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance; and (iv) federal income tax issues raised by transactions involving finite risk. These four areas should be considered "hot topics" of future captive insurance rulings by the IRS.

IRS Notice 2006-42, issued May 8, 2006: This Notice generally defines "gross receipts" for purposes of IRC §501(c)(15) as premiums plus gross investment income, including interest, dividends, rents, royalties, and capital gains. That is, the "cost basis" of the sale of a capital asset is excluded from the calculation. The main unresolved issue continues to be whether capital gains can be offset by capital losses and capital loss carry forwards. The Notice does not directly address the loss issue; however, it provides that gross receipts include the items described in IRC §834(b) which includes "gains" from the sale of capital assets (including securities).

Capital losses are described in IRC §834(c), not (b). As such, for planning purposes, it should be assumed that capital gains will be included and that capital losses will not reduce such gains or other investment income.

The Notice does not take into account (nor does it discuss) the legislative history of IRC §501(c)(15). The net written premium standard of pre-2004law was adopted as part of the Tax Reform Act of 1986 ("1986 Act"). Prior to the 1986 Act, IRC §501(c)(l5) provided exemption for mutual non-life insurance companies if the gross amount received during the taxable year from the items described in IRC §822(b) (other than paragraph (1)(D), dealing with the capital gains) and premiums did not exceed $150,000. Thus, the last time, prior to the 2004 Act, that IRC §50l(c)(l5) was based on a gross receipts test, capital gains and losses were excluded from the test. In fact, Treas. Reg. §1.501(c)(l5)-1, which has remained unchanged since 1963, follows the pre-1986 exemption standard of excluding capital gains. Thus, the regulation provides that a $150,000 ceiling applies to the exemption, measured by the gross amount of interest, dividends, rents, and royalties. Capital gains on securities sales are excluded.

IRS pronouncements, such as notices and rulings, carry weight if long-standing and reasonable but do not carry the weight of a regulation, statute or case law. Since the Notice is contrary to Treas. Reg. §1.501(c)(15)-1, its validity may be at issue. However, since this is a highly technical issue and likely requiring litigation to overturn the Notice with respect to the capital gains and loss issue, our recommendation is to

assume that capital gains are included as a gross receipt and that capital losses do not reduce capital gains.

PLR 200714015, issued April 6, 2007: This ruling granted relief for a late filed §831(b) election where the captive's tax advisor was not aware that gross receipts of all members of a controlled group were counted for purposes of qualifying under §501(c)(l5). Generally, a §831(b) election is not timely unless it is made on a timely return.

PLR 200724040, issued June 15, 2007: This ruling discusses issues regarding risk distribution and the requirement that the captive write enough diverse exposures to incorporate the "law of large numbers".

IRS Revenue Ruling 2007-47, issued July 2, 2007: This ruling involves a purported insurance arrangement where there is no uncertainty that future costs will be incurred. The only uncertainty is the amount and timing of these costs. The IRS ruled that an amount paid to an insurance company to cover such future losses does not constitute insurance, because "from an insurance standpoint there is no risk unless there is uncertainty, or, to use a better term, fortuitousness." This ruling is highly debated by insurance experts, and future rulings in this area are expected.

SOME CONCLUDING GENERALIZATIONS

Captive insurance and insurance in general does not provide exact "bright line" tests in all areas, but the law is much more settled and favorable than it was even a few years ago. Some concluding generalizations can be gleaned. What follows are our opinions and should be treated as such.

1. Both risk shifting and risk distribution must be present in order for an arrangement to constitute an insurance arrangement for federal income tax purposes. With Revenue Ruling 2001-31, risk shifting can be met by paying insurance premiums to a separate insurance company (that is not part of a consolidated group with the business).
2. In defining risk distribution, the IRS is focusing on a number of issues, including (a) the number of policyholders involved in the transaction, (b) the number of risk units, (c) whether there is any finite risk present, and (d) whether the insured is substantially paying for its own risks. Our recommendation is for clients to meet the IRS safe harbor provisions set forth in these revenue rulings.
3. An important factor to the IRS is that the insurance arrangement involves "insurance" in its commonly-accepted sense. Included in this is the variety of factors (adequate capitalization, non-tax business purpose, arm's-length and commercial dealing, regulatory oversight, investments, reinsurance/pooling) that the IRS views as favorable or unfavorable regarding captive insurance. We have tried to identify these key factors in this Memorandum. The captive must also meet normal inter-company transaction requirements, such as arms-length pricing, proper documentation, business purpose, etc.
4. To be considered an insurance company the company's primary business must be "insurance" and insurance premiums must be "more than half" the entire business of the captive. As such, a heavy emphasis by the captive on business unrelated to this primary purpose (e.g., loans between the insurance company and affiliates, excessive capital contributions, emphasis on investment activities in the insurance company, etc.) can lead to a determination that the company is not an insurance company. In general, captive investments should resemble those of larger insurance companies, i.e., diversified, conservative, independent.

The above summary in our view represents the state of the tax law regarding captive insurance companies. As stated initially, this summary is not a substitute for review by your clients' own tax professional(s).

It is impossible to guaranty that the IRS will not challenge any particular captive arrangement. In the future, certain tax laws or the interpretation thereof may change. This is not a legal or tax opinion letter. There has been a significant liberalization over the last 30 years regarding captive insurance companies, and we believe this will continue as the industry grows. We hope that this memorandum is helpful in understanding the history of captive insurance, and the tax rules involved in forming and managing a captive insurance company.

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