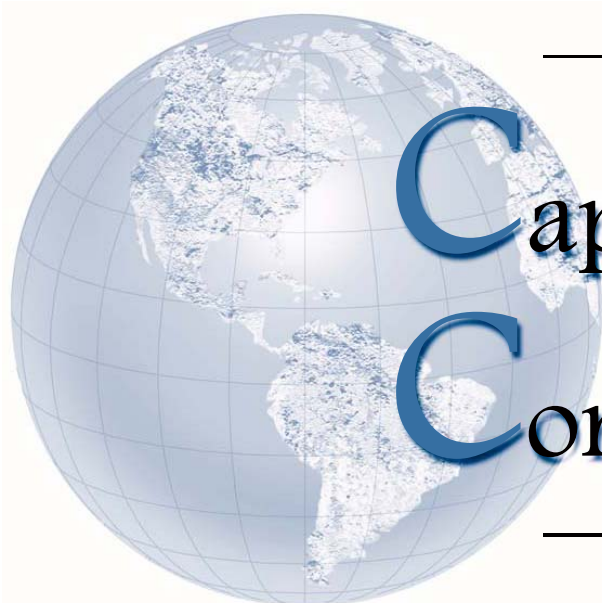


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# Captive Insurance Company Reports

## **IRS Weighs in on Cell Captives**

*Editor's Note:* The following was presented to *CICR* by **P. Bruce Wright, Esq.**, of Dewey & LeBoeuf LLP in New York.

For some years, there has been confusion about how to determine whether a transaction should be treated as one of insurance when undertaken with a cell in a protected cell company (PCC). In 2005 the Internal Revenue Service (IRS) issued IRS Notice 2005-49, in which it requested comments on the treatment of cell companies. On January 15, 2008, the IRS issued Revenue Ruling 2008-8 and Notice 2008-19 in which, respectively, the IRS provided guidance with respect to the characterization of insurance transactions with a cell and proposed guidance with respect to treat-

ment of a cell for other federal income tax purposes.

### **Revenue Ruling 2008-8**

In Revenue Ruling 2008-8, the IRS has indicated its intention to essentially treat each cell of a PCC as a separate entity for purposes of determining whether the arrangements with the cell should be characterized as insurance. To illustrate, in the ruling, the PCC established multiple cells, each with its own name and identified with a specific preferred shareholder (i.e., its participant) that owned all of the nonvoting preferred shares associated with such cell. Each cell was funded by its participant's capital contributions and premiums from the cell's "insurance" contracts. Each cell was required to pay all claims on such contracts. The income, expenses, assets, liabilities, and capital of each cell were accounted for separately (distinct from any other cell or

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the PCC), and each cell's assets were statutorily protected from the creditors of any other cell and the PCC.

The PCC also maintained assets, representing the minimum amount of capital required by local law, separate from any cell. Distributions from a cell could be made to its participant regardless of whether distributions were made from any other cell. Participants were entitled to a return of its cell's assets (subject to the cell's liabilities) at the time the

participant ceased its participation in the PCC. In Revenue Ruling 2002-89, 2002-2 C.B. 984, and Revenue Ruling 2002-90, 2002-2 C.B. 985, the IRS considered, respectively, situations in which (1) a parent company dealt with its wholly owned captive, and (2) a captive owned by an affiliated group insured a diverse group of its sister operating entities.

The ruling considers two factual scenarios. In the first, X, a U.S. corporation that owns all of the preferred shares issued with respect to Cell X, enters into a 1-year contract, pursuant to which professional liability risks of X are insured either directly or indirectly as reinsurance with Cell X. Following Revenue Rulings 2002-89 and 2005-40, 2005-2 C.B. 4, the Ruling notes the following:

- ✓ Premiums are established according to customary industry rating formulas.
- ✓ X and Cell X conduct business consistent with insurance arrangements between unrelated parties.
- ✓ Cell X may perform necessary administrative tasks or outsource those tasks at prevailing market rates.
- ✓ X does not provide any guaranty of Cell X's performance.
- ✓ Business records of X and Cell X are separately maintained.
- ✓ There are no loans from Cell X to X.
- ✓ X is adequately capitalized relative to the risks assumed under that insurance arrangement between X and Cell X.

The Ruling also notes that Cell X has not entered into any other arrangements with any other party. The Ruling provides that:

The arrangement between X and cell X is akin to an arrangement between a



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parent and its wholly owned subsidiary, which, in the absence of unrelated risk, lacks the requisite risk shifting and risk distribution to constitute insurance.

Accordingly, the IRS concludes that the arrangement between X and Cell X is not an insurance contract for federal income tax purposes. For this conclusion the IRS cites both Revenue Ruling 2002–89 (regarding a similar fact pattern involving a parent corporation and its wholly owned insurance subsidiary) and Revenue Ruling 2005–40, which concludes that an arrangement lacks necessary risk distribution and, accordingly, would not be characterized as insurance for federal income tax as the insurer contracts with only a single policyholder.

In the second example, Y, also a domestic corporation, purchases all of the preferred shares with respect to Cell Y. Y also owns all of the preferred shares of its 12 domestic subsidiaries, which are described as operating in geographically diverse areas. Further, the general categories of the services rendered by each of the subsidiaries are the same throughout the group. Each subsidiary of Y enters into a 1-year contract with Cell Y, pursuant to which Cell Y insures the professional liability risks of the subsidiary either directly or as a reinsurer. Following Revenue Ruling 2002–90, the Ruling notes:

- ✓ Premiums are established according to customary industry rated formulas.
- ✓ None of the subsidiaries have liability coverage for less than 5 percent or more than 15 percent of the total risk insured by Cell Y.
- ✓ Cell Y does not reinsure any of the risk that it assumes.
- ✓ Y, Cell Y, and each subsidiary conduct themselves consistently with insurance industry standards among unrelated parties.
- ✓ Cell Y may perform all necessary administrative tasks or outsource those tasks at prevailing market rates.
- ✓ Neither Y nor any subsidiary of Y guarantees Cell Y's performance.
- ✓ All funds and business records of Y, Cell Y, and each subsidiary are separately maintained.
- ✓ There are no loans from Cell Y to Y.
- ✓ No similar arrangements are entered into by Cell Y other than those with Y and its subsidiaries.
- ✓ Cell Y is adequately capitalized.

Relying on Revenue Ruling 2002–90, the IRS concludes that the premiums paid by each Y subsidiary to Cell Y are deductible. Accordingly, as Revenue Ruling 2008–8 establishes a standard for deductibility of premiums paid to cell companies that parallels the position the IRS has taken with regard to “freestanding” captive insurance companies. Accordingly, one would expect that the same position would be taken with respect to a cell writing sufficient unrelated business. *See* Revenue Ruling 2002–91, 2002–2 C.B. 991; *Harper Group v. Commissioner*, 96 T.C. 45 (1991) *aff'd* 979 F.2d 1341 (9th Cir. 1992); *Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993).

In IRS Notice 2008–19, a companion document to Revenue Ruling 2008–8, the IRS requested comments (due May 5, 2008) relating to proposed guidance addressing issues that arise if cell company arrangements constitute insurance with respect to the status of a cell as an insurance company and the consequences of a cell's status as an insurance company. In general, the proposed guidance in the Notice appears to treat cells as separate entities and provides for the following proposed guidance:

- ✓ Tax elections that would be available by reason of a cell's status as an insurance

company would be made by either the cell, or if the cell was deemed to be part of a consolidated group, by the parent of the group.<sup>1</sup>

- ✓ The cell would be required to apply for its own U.S. employer identification number (if such was required for U.S. federal income tax purposes).<sup>2</sup>
- ✓ The activities of the cell would be disregarded for purposes of determining whether the PCC should be characterized as an insurance company for U.S. federal income tax purposes.
- ✓ If the cell was subject to U.S. federal taxation, the cell (or in the consolidated group context, the parent of the consolidated group on the cell's behalf) would be required to file applicable U.S. federal tax returns and pay all taxes with respect to its income.
- ✓ Finally, a PCC would not take into account any items of income, deduction, reserves, or credit with respect to any cell that is treated as an insurance company.

If the foregoing proposed guidance were implemented, then questions would arise as to how income earned in the PCC, separate from any cell characterized as an insurance company, might be taxed to a U.S. sponsor/common shareholder of the PCC. For example, if no insurance were written except by cells, the IRS might take the position that the PCC was

<sup>1</sup>This would permit a cell, for example, to make an election under § 953(d) of the Internal Revenue Code of 1986, as amended, to be treated as a domestic "insurance company" for U.S. federal income tax purposes. In addition, it would presumably permit the cell to be taxed under § 831(b) of the Code (which permits an insurance company with less than \$1.2 million in gross premium to be taxed on its investment income).

<sup>2</sup>This would likely be necessary, for example, if the cell invests in assets in the United States, undertakes to pay the federal insurance excise tax imposed by § 4371 of the Code on behalf of its insureds, or makes an election under § 953(d) of the Code.

a controlled foreign corporation (CFC). This may, however, not have disadvantageous tax consequences if the CFC's only earnings were a small amount of investment income<sup>3</sup> and be services income (fees from managing the various cells),<sup>4</sup> because this income may not be characterized as subpart F income, and, accordingly, would not be includible in the U.S. federal gross income of a U.S. sponsor/common shareholder.

Additionally, if a cell were treated as a CFC, the cell's participant (if a U.S. person) likely would be required to include all of the income of the cell in its U.S. federal gross income on a current basis. This consequence may not be so different for those participants in cell companies who already include related person insurance income (RPII) pursuant to the CFC provisions of subpart F in their U.S. federal gross income. However, this consequence would present a difference for those participants not required to include in their U.S. federal gross income any amount under subpart F income at the present time. Under an alternative scenario, if the cell were to make an election under § 953(d) of the Code (i.e., to be treated as a domestic entity), it might be consolidated with its preferred shareholder/parent corporation, as would a captive making an election under § 953(d).

In addition, the proposed guidance would have presented an interesting interplay with Proposed Regulation § 1.1502-13(e), which denied a deduction for reserves to any captive with respect to liabilities insured with the captive arising from members of the consolidated group in which the captive (or, presumably based on the proposed guidance, a cell in the case of a PCC) participates.<sup>5</sup>

Issues arising as a result of the Proposed Regulation, however, were eliminated on

<sup>3</sup>See § 954(b)(3) of the Code.

<sup>4</sup>See § 954(e) of the Code.

<sup>5</sup>This proposed regulation is not final; hearings were scheduled for February 29, 2008.

February 20, 2008, when it was announced that the Proposed Regulation would be withdrawn. Clearly, many other issues may be dealt with when comments are submitted with regard to the proposed guidance in Notice 2008-19.

All in all, the captive industry is now faced with a number of interesting precedents—the new Revenue Ruling, and the proposed guidance in the Notice. It will be interesting to see what positions the IRS will ultimately take on these matters and the response of the industry thereto. ■

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