# Taxes and Your Captive

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# Agenda

US FEDERAL TAX UPDATE

STATE TAX UPDATE

QUALIFYING AS AN INSURANCE COMPANY

ISSUE SPOTTING

# US Federal Tax Update

# US Federal Tax Updates

- No significant tax policy matters are expected to be ratified in the next 2 years other than 831(b) regulations

- Federal Excise Tax ("FET") - The IRS continues to focus on FET collection and payments and Sec 953(d) Elections

    - Sec 953(d) election delays

- Pillar 2 considerations

- IRS Priority List - Insurance

# US Federal Tax Updates (Continued)

- 15% Corporate Alternative Minimum tax
  - Corporations with average annual AFSI greater than USD $1b over three consecutive tax years.
  - Foreign-parented companies must meet separate USD $100m income test related to US operations.
  - CAMT will be accounted for in accordance with Accounting Standards Codification (ASC) 740-10-25-42 through 44 and ASC 740-10-30-10 through 12.
  - Deferred taxes will continue to be measured using the regular tax rate, not the AMT rate. Companies expecting to be in CAMT indefinitely may want to consider the impact on valuation allowances on existing deferred tax assets.
  - Notices 2023-7 and 2023-20

# Recent Court Cases of Interest

- United States v. Delaware Department of Insurance, No. 21-3008 (3d Cir. 2023)
  - Third Circuit refused to reconsider its decision directing Delaware insurance regulators to comply with an IRS summons and hand over their communications with “micro-captive” companies and managers

# State Tax Update

# State Taxation

- Corporate State Tax vs. State Premium Tax
- Self-Procurement Tax
- Unitary/Combined rules
- Types of income and nexus
    - Captives with “services” income or Services Co ownership where Service Co is a SMLLC

# US state and local update

- General considerations
  - Continued focus by state DORs on inclusion/exclusion of a captive insurance company from Unitary/Combined filings
    - Localities joining in on the legislation where current guidance is silent or ambiguous
  - Related party add-back issues (e.g., Illinois add-back provisions)
  - Expected changes in legislation (most likely adverse to taxpayers) may result in additional state and local tax liability for the overall combined groups
- Warranty and obligor companies
  - Subject to state and local tax or not?
    - Registration and regulation details

# US state and local update

- Self Procurement Tax
  - What is SPT?
  - Who is liable for SPT?
    - What happens in an affiliated group of companies with more than one insured?
  - Real estate captives writing damage waiver and credit risk coverage
  - SPT in corporate reorganization – can SPT liability apply twice, etc.?

# US state and local update

- Self- or Independent Procurement Tax
- Tax is paid by the named insured on the policy for premiums paid to an insurer not authorized in the state.
  - 45-46 states impose a self-procurement tax.
  - Rates from 0.5% (IL) to 6% (OK, SC).
  - Other states either don’t impose the tax or statutory language would put burden on the unauthorized company.
  - NY – historically has always enforced this tax.
  - Nonadmitted Reinsurance Reform Act (15 USC §8201 et. seq.) sets forth the rules for determining the state (only one) where tax is to be paid.

# US state and local update

- Washington State
  - The tax/fee/licensing of out-of-state captives applies to any captive that has an owner that has its principal place of business in Washington.
    - Must register and annually pay a fee of $2,500; and
    - Must pay an annual premium tax on 2% of premiums directly procured by the captive on **Washington risks**.
    - Reinsurance assumed is not taxable; unclear on how ocean marine premium would be treated.
    - Principal place of business not defined (NY uses “nerve center” test from *Hertz Corp. v. Friend* for SPT).

Self Procurement Tax – "toll charge"

# US state and local update

| Direct Procurement Tax Range | States |
| --- | --- |
| No Law | DC, GU, IN, MA, SC, VA, WA, WV |
| 0.50% to 2.50% | AR, ID, IL, IA, KY, MI, MN, ND, OR, SD |
| 2.51% to 3.50% | AZ, CA, CO, DE, ME, MD, MS, MT, NE, NV, NM, PA, VT, WI, WY |
| 3.51% to 4.50% | AL, AK, CT, GA, NH, NY, RI, UT |
| 4.51% to 5.50% | FL, HI, LA, MO, NC, NJ, OH, TN, TX, USVI |
| Over 5.50% | KS, OK, PR |

# Qualifying as an Insurance Company

# Qualifying As an Insurance Company

The following criteria must be met for a captive to be treated as an insurance company for federal income tax purposes:

- **Definition of an insurance company**
  - An "insurance company" is a company where more than half business of which is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Sections 831(c) and 816(a).
- **Insurance risk must be involved**
  - The risks transferred from the insured must involve fortuity and constitute more than mere "investment" or "business" risk
- **Risk transfer or shifting must occur in the transaction**
  - Risk shifting requires the transfer of economic consequences of a financial loss away from the entity (the insured) that is paying the premium. In other words, the insured entity pays the insurer an amount certain to bear its risk of loss.
- **The captive must sufficiently distribute the risks that it holds**
  - Risk distribution requires the pooling of funds by the insurer in order to spread the economic consequences of claims over a group that is large enough to yield predictable losses. There are several ways to achieve risk distribution, including:
    - The Safe Harbor Rule set forth by Revenue Ruling 2002-89
    - The Safe Harbor Rule set forth by Revenue Ruling 2002-90
    - Case law established in *Rent-A-Center* and *Securitas*
- **The captive arrangement must comport with "commonly accepted notions" of insurance**
  - Regulatory oversight and adequate capitalization
  - Pays losses as claims are made
  - Other, less well-defined criteria

# Issue Spotting

# Issue Spotting

- State
  - Corporate State Tax vs. State Premium Tax
  - Self-Procurement Tax
  - Unitary/Combined rules
  - Types of income and nexus
- Qualification – Contemporaneous Documentation
  - Best practice to document qualification status at the time a captive is formed and anytime changes to the insurance program, structure, etc. occur

# Investment Strategies

| | Type of Investment* | Combined assets in this category generally could reach X% of total assets: |
|---|---|---|
| | Cash and time deposits† | 100% |
| | Money market instruments - If issued by a government money market mutual fund or an SVO approved money market mutual fund (Class 1 fund) | |
| | U.S. Gov't fixed income -- issued, assumed, guaranteed, insured by, or otherwise backed by the full faith and credit of U.S. Government. | |
| | Publicly-quoted investments (i.e., commercial paper, bonds, equities) | |
| | Municipal Bonds, General Obligation Bonds, Revenue Bonds | |
| | | |
| | Mortgage-related securities | TBD Based on Facts & Circumstances |
| | Asset-backed securities | |
| | | |
| | Multi-party pooling agreement involving a bank | TBD Based on Facts & Circumstances |
| | Participation in Cash sweep arrangements with parent | |
| | Insurance-linked securities: Catastrophe bonds, Life-insurance linked securities** | |
| | Real estate (as a portfolio investment) | |
| | | |
| | Real estate (specific properties) | TBD Based on Facts & Circumstances |
| | | |
| | Factoring parent/affiliate receivables | TBD Based on Facts & Circumstances |
| | Equipment/Asset purchase and leaseback | |
| | Unsecured Loans to parent and/or affiliates | |
| | Parent common stock | |
| | Parent commercial paper | |

* Based on Tax Court's rulings in *Rent-a-Center, Securitas*, IRS's pronouncements in Rev. Rul. 89-91, and Deloitte's years of experience (anecdotal) with clients in IRS audits. See following page for a list of cases and rulings which address assets of a captive insurance company.

† Assumes that the company will always maintain sufficient cash to cover claim payments that are immediately due, as well as G&A expenses.

# Investment Strategies

| Authority; Case | Discussion | Type of Assets | Takeaway |
|---|---|---|---|
| *Avrahami v. Comm'r, 149 TC No. 7 (2017)* | • Captive held cash and "mortgage and real estate loans" (65% of the captive's assets were in long-term, illiquid, and partially unsecured loans to related parties) | • Related party loans | • The captive's assets were noted as cutting against the "insurance in the commonly accepted sense" test. |
| *Rent-A-Center v. Comm'r, 142 T.C. No. 1 (2014).* | • Tax Court approved parental guaranty of deferred tax assets held in adequately capitalized captive insurer<br>• Captive also owned treasury shares in parent; such shares were treated as general business assets for purposes of measuring liquidity<br>• Captive's assets were: (i) guarantees issued by parent; (ii) DTAs; (iii) parent treasury stock purchased from parent | • Guarantees issued by parent<br>• DTA<br>• Parent treasury stock purchased from parent | • Substantial DTAs can be held by a captive and counted as approved assets<br>• Treasury shares in parent are allowable |
| *Securitas v. Comm'r, T.C. Memo 2014-225* | • Captive insurance arrangement shifted economic consequence of risk from corporate taxpayer's subsidiaries to captive insurer and then to captive reinsurer, as required for premiums to be deductible business expenses; taxpayer guaranteed captive insurer's performance, but only to preserve tax-exempt status of another captive insurer in same control group, and nothing was paid out under guaranty, insurer and reinsurer were adequately capitalized when considered together, and subsidiaries' journal entries tracked flow of funds through insurer and reinsurer, even if checks cut did not show insurer's role. | • Guarantees issued by parent | • Parental guarantees can be allowable asset for captive insurer |
| *FSA199945009 (July 29, 1999)* | • A reinsurance company made certain loans to a related finance company | • Related party loan | • Loans made to a related company that create circular flows of cash could undermine a taxpayer's argument that the insurance company was an independent entity that negotiated the terms of the "insurance" transactions at arm's length. |
| *IRS Notice 2016-66 (Nov. 2, 2016)* | • The following scenario is considered potentially abusive in Notice 2016-66: Captive loans or otherwise transfers its capital to Insured, entities affiliated with Insured, the Insured's owners, or persons related to Insured's owners. | • Intercompany loans from captive to insureds, owners of captive, or other related parties. | • Circular flows of cash from captive to related entities are discouraged. |

# Loss Portfolio Transfer

- In the context of Captive insurance, the parent company of a captive may transfer its self-insured reserves to the captive through a Loss Portfolio Transfer ("LPT"). When a captive accepts parental risk through an LPT, the captive assumes and accepts the parent's existing open and future claim liabilities.
- A LPT is form of reinsurance that involves the transfer of a portfolio of loss liabilities from the parent to the captive at an agree upon price. As a result of the transfer, the parent may limit its liability in the portfolio. The consideration that the parent receives is based on a discounted cash flow analysis of loss reserves plus a reinsurer loading. The transfer results in a gain for the Parent that is deferred for GAAP and SAP. The gain can be recognized once the cash recovered from the loss reserves ceded exceeds the premium paid to the Captive. At that point, the gain is recognized as the Captive's recoveries are collected.
- By its nature, an LPT is a form of reinsurance and is thus subject to requirements that are applied to reinsurance contracts. Under SSAP 62 and ASC 944, reinsurance contracts require two elements: (1) the reinsurer must assume "significant insurance risk," and (2) the reinsurer must be at risk of realizing "significant loss" from the transaction. Further in Securitas, the Tax Court held that premiums, including those attributable to an LPT, were deductible so long as judicial precedent outlining the qualifying tests for an "insurance company" are satisfied.
- Furthermore, if an LPT does not satisfy the requirements for an "insurance company" under the relevant accounting and legal principles, then, upon a challenge by the IRS, the captive holding the parent risk will be disregarded and the transaction will be reconstrued as self-insurance, preventing the captive from receiving insurance tax treatment.

# Section 831(b) Proposed Regulations

- April 11, 2023: IRS issued proposed regulations affecting most captive insurance companies making a Section 831(b) election
- New regulations make Notice 2016-66 obsolete
- "Upgrade" from Notice 2016-66 – many Section 831(b) captives become listed transaction instead of transaction of interest
- If the captive meets the definitions in the proposed regulations, it must file Form 8886. Material advisors must file Form 8918. Same forms as Notice 2016-66.
- Many captives and material advisors have been filing these forms since Notice 2016-66 – even after it was vacated by the District Court.
- "Micro-captives" are a **listed transaction** if either:
    - Over the most recent 5-year reporting period, there is a financing agreement between the captive and a related party (*e.g.*, loanbacks); or
    - Over a 10-year reporting period, the captive has a loss ratio of less than 65%

- "Micro-captives" are a **transaction of interest** if:
    - The captive issues a contract to the insured or reinsures a contract issued to the insured by an intermediary
    - The captive has a loss ratio of at least 65% if the captive has been in existence less than 10 years and no financing arrangement

# Questions?

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