

# NAVIGATING TO SUCCESS

## Federal and State Taxes, Case Law and IRS Developments

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# NAVIGATING TO SUCCESS

## AGENDA

- RECENT CAPTIVE CASES
- RESIDUAL VALUE AND OTHER INSURANCE RISKS
- MEDICAL STOP LOSS
- ACTIVITY RELATING TO CAPTIVES MAKING A SECTION 831(B) ELECTION AND THEIR AGGREGATORS
- DIRECT PROCUREMENT TAX
- FOREIGN CAPTIVE ISSUES

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## IRS 2015-2016 PRIORITY GUIDANCE PLAN

ISSUED ON JULY 31, 2015

TWO ITEMS RELATED TO CAPTIVE TAXATION

- “FINAL REGULATIONS UNDER §7701 REGARDING SERIES LLCs AND CELL COMPANIES. PROPOSED REGULATIONS WERE PUBLISHED ON SEPTEMBER 14, 2010”
- “GUIDANCE RELATING TO CAPTIVE INSURANCE COMPANIES”

NO ONE SEEMS TO KNOW WHAT SPECIFICALLY THE SECOND ITEM IS INTENDED TO ADDRESS

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## RECENT CAPTIVE CASES



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## RENT-A-CENTER TAX COURT DECISION

DIVIDED OPINION ISSUED 1/14/14 IN FAVOR OF TAXPAYER

- REVIEWED BY FULL COURT – 16 JUDGES (ONE RECUSED HIMSELF)
- 4 OPINIONS: MAJORITY, CONCURRING AND 2 DISSENTING

MAJORITY FOUND ALL MAJOR TAX REQUIREMENTS WERE PRESENT:

- RISK SHIFTING (DISSENT DISAGREED)
- RISK DISTRIBUTION (DISSENT POSITION UNCLEAR)
- COMMON NOTIONS OF INSURANCE (DISSENT DISAGREED)

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## RENT-A-CENTER TAX COURT DECISION

APPLYING FACTS & CIRCUMSTANCES TEST,  
PREMIUM DEDUCTION OF \$43 MILLION BY SISTER  
SUBS WAS UPHELD (NO PREMIUM WAS  
ALLOCATED TO RAC ITSELF, A PURE HOLDING  
COMPANY)

IRS DECIDED NOT TO APPEAL – PERHAPS TOO  
FACT SPECIFIC

RISK UNITS

- APPROXIMATELY 2,400 STORES
- BETWEEN 14,300 AND 19,740 EMPLOYEES
- APPROXIMATELY 2,400 VEHICLES

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## RENT-A-CENTER CASE KEY FACTS

RAC A PUBLIC COMPANY IN “RENT-TO-OWN”  
BUSINESS

FORMED LEGACY IN BERMUDA IN 2002; MADE  
953(D) ELECTION

RISKS OF APPROXIMATELY 15 SUBS WERE  
COVERED; **LARGEST SUB ACCOUNTED FOR  
ABOUT 2/3 OF TOTAL RISK** (LATTER PERCENTAGE  
NOT STATED IN OPINION)

RAC PAID PREMIUMS TO LEGACY ON BEHALF OF  
SUBS AND USED ITS COST ACCOUNTING  
FORMULA TO ALLOCATE PREMIUM EXPENSE  
BASED ON EACH SUB’S EXPOSURE UNITS

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## RENT-A-CENTER CASE KEY FACTS

STANDARD COVERAGES – W/C, AUTO AND  
GENERAL LIABILITY

STRUCTURED AS A DEDUCTIBLE BUY-BACK  
PROGRAM

INDEPENDENT ACTUARY AND THIRD PARTY  
ADMINISTRATOR



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## RENT-A-CENTER CASE MAJORITY OPINION

IRS SHAM ARGUMENT REJECTED; LEGACY FORMED FOR VALID NON-TAX BUSINESS PURPOSES

RISK CLEARLY SHIFTED TO LEGACY FROM SUBS (BUT NOT PARENT)

MAJORITY OF JUDGES NOW ACCEPT BROTHER/SISTER THEORY (REJECTED BY TAX COURT IN HUMANA IN 1987) BASED ON EITHER FACTS/CIRCUMSTANCES OR IRS CONCESSION OF THE ECONOMIC FAMILY DOCTRINE IN REV. RUL. 2001-31

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## RENT-A-CENTER CASE MAJORITY OPINION

THE 6TH CIRCUIT IN HUMANA APPEAL HELD IN 1989 THAT THE TAX COURT HAD ERRED ON THIS POINT, SO NOW 15 TAX COURT JUDGES VOTED ON WHETHER TO OVERRULE OR KEEP ITS PAST BROTHER/SISTER POSITION (GIVEN THAT THIS CASE'S APPEAL GOES TO A DIFFERENT (THE 5TH) CIRCUIT)

AS STATED, A MAJORITY OF JUDGES NOW AGREE THAT THE BROTHER-SISTER THEORY WORKS TO CREATE RISK SHIFTING/DISTRIBUTION, MAKING APPLICATION OF THE "BALANCE SHEET" TEST THE OFFICIAL TAX COURT POSITION

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## RAC: RISK SHIFTING TAKE-AWAY

### REFINING IMPACT OF A PARENT GUARANTY

- MAJORITY OPINION FOUND RAC'S LIMITED GUARANTY OF LEGACY DID NOT PREVENT RISK SHIFTING
- FACTS & CIRCUMSTANCES TEST: "WE MUST LOOK TO THE SUBSTANCE OF THAT GUARANTY"
  - LEGACY MORE THAN ADEQUATELY CAPITALIZED (DISSENT DISAGREED)
  - GUARANTY PROVIDED BY PARENT, NOT BY INSURED SUBS OWNING NO LEGACY SHARES
  - GUARANTY IN FAVOR OF CAPTIVE NOT FRONTING CARRIER (AS IN PRIOR CASES)

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## RAC: RISK SHIFTING TAKE-AWAY

- REGULATORY PURPOSE FOR GUARANTY – SO BMA WOULD RECOGNIZE LEGACY'S DEFERRED TAX ASSET FOR STATUTORY RATIOS
- \$25M AMOUNT RELATIVELY SMALL COMPARED WITH \$264M PREMIUMS
- GUARANTY NEVER USED & REMOVED WHEN NO LONGER NEEDED FOR BMA

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## RAC: RISK DISTRIBUTION TAKE-AWAY

- DISSENT SAYS EXISTENCE OF RAC GUARANTY SHOULD NEGATE “RISK SHIFTING”
- REFINING MEANING OF “RISK DISTRIBUTION”
- MAJORITY OPINION PRIMARILY FOCUSED ON RISKS, NOT ON ENTITIES: “RAC’S SUBS HAD A SUFFICIENT NUMBER OF STATISTICALLY INDEPENDENT RISKS”
- JUDGE FOLEY LOOKED AT NUMBER OF STORES, EMPLOYEES AND VEHICLES



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## RAC: RISK DISTRIBUTION TAKE-AWAY

- EXPANSION OF HUMANA DOCTRINE WILL PROVIDE A MUCH EASIER PATH TO ACHIEVING INSURANCE STATUS (EXCEPT FOR PARENT RISK)
- COULD REDUCE NEED FOR RISK POOLS AND OTHER MEANS OF FINDING UNRELATED RISK TO PLACE IN A CAPTIVE
- REV. RUL. 2002-90 CITED BY MAJORITY ONLY FOR IRS RECOGNITION OF VALIDITY OF HUMANA CONCEPT – IRS REQUIREMENT OF 12 SUBS EACH BETWEEN 5%-15% OF TOTAL RISK (PREMIUMS) IMPLICITLY REJECTED BY MAJORITY

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## **RAC: LOAN BACK ISSUE**

LEGACY'S PURCHASE OF \$108 MILLION OF RAC TREASURY SHARES

- TREASURY SHARES BOUGHT AND HELD BY LEGACY DURING YEARS IN ISSUE
- JUDGE FOLEY SAID NO CIRCULAR CASH FLOW BECAUSE SHARES NOT SOLD

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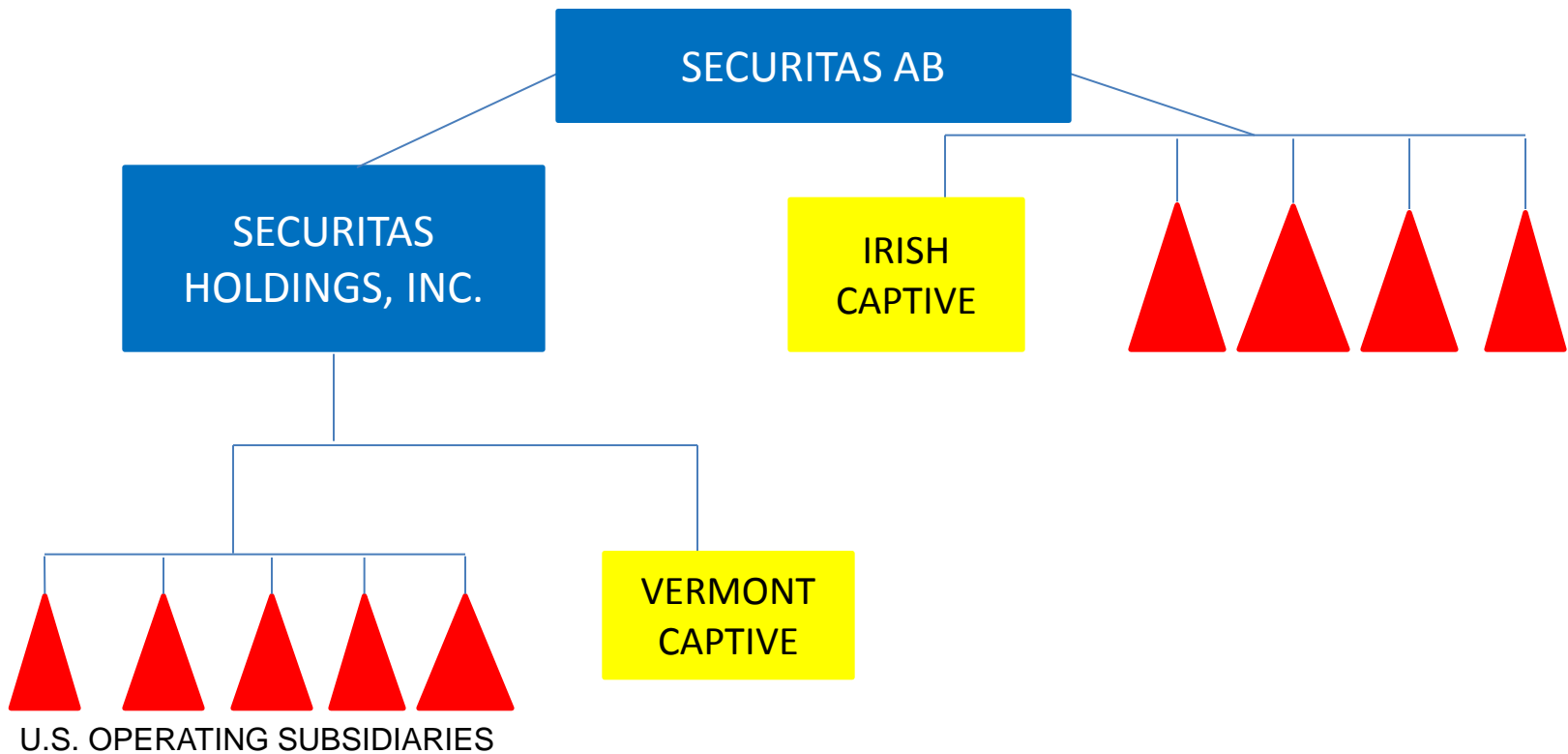
## RAC: LOAN BACK ISSUE

- DISSENT SAID TREASURY SHARES WERE A FACTOR IN CHARACTERIZING LEGACY AS “A MERE HOLDING TANK FOR CASH”
  - BECAUSE THE SHARES WERE NON-INCOME PRODUCING AND ILLIQUID, DISSENT SAID THEY WERE POORLY SUITED FOR AN INSURANCE COMPANY’S INVESTMENTS
  - PLUS DISSENT FOUND A NEGATIVE CORRELATION SUCH THAT IF RAC EXPERIENCED LARGE LOSSES, THE VALUE OF THE SHARES WOULD DECLINE WHEN MOST NEEDED BY LEGACY
  - COUPLED WITH THE GUARANTY AND LOW CAPITALIZATION, DISSENT SAID NO RISK WAS SHIFTED TO LEGACY

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## SECURITAS HOLDINGS, INC. & SUBSIDIARIES V. COMMISSIONER

CASE INVOLVES CORPORATE GROUP AS FOLLOWS:



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## **SECURITAS HOLDINGS, INC. & SUBSIDIARIES V. COMMISSIONER**

RISKS OF U.S. OPERATING SUBS INSURED WITH  
VT CAPTIVE OWNED BY U.S. HOLDING COMPANY,  
SHI

SHI PROVIDED GUARANTY TO VT CAPTIVE SO VT  
CAPTIVE NEVER TREATED AS AN INSURANCE  
COMPANY IN SHI TAX RETURN

PREMIUM FROM 1 U.S. SUB ACCOUNTED FOR  
ABOUT 2/3 OF PREMIUMS OF VT CAPTIVE

4 U.S. SUBS CONSTITUTED > 90% OF PREMIUM OF  
VT CAPTIVE



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## **SECURITAS HOLDINGS, INC. & SUBSIDIARIES V. COMMISSIONER**

VT CAPTIVE CEDED 100% OF PREMIUM TO IRISH  
CAPTIVE OWNED BY SWEDISH PARENT

PREMIUM FROM NON-U.S. SUBS WRITTEN BY XL  
AND REINSURED IN PART TO IRISH CAPTIVE

IRS POSITION: VT CAPTIVE IS NOT AN INSURER  
BECAUSE OF GUARANTY; IRISH CAPTIVE IS NOT  
AN INSURER BECAUSE OF CONCENTRATION OF  
RISK AND VT CAPTIVE RISK GUARANTEED

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## **SECURITAS HOLDINGS, INC. & SUBSIDIARIES V. COMMISSIONER**

HOLDING FOR TAXPAYER IN TAX COURT  
MEMORANDUM DECISION WITH COMMENT THAT  
WHO OWNS THE RISK IS NOT THE CRITICAL  
QUESTION; RATHER THE NUMBER OF RISKS  
RESULTING FROM THOUSANDS OF LOCATIONS,  
EMPLOYEES & VEHICLES ARE KEY

RISK UNITS – MORE THAN 200,000 EMPLOYEES,  
MORE THAN 2,250 VEHICLES, AND LOCATIONS IN  
20 COUNTRIES

IRS OPTION TO APPEAL TO 9TH CIRCUIT EXPIRED  
1/28/15

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## DEDUCTIONS FOR PREMIUMS

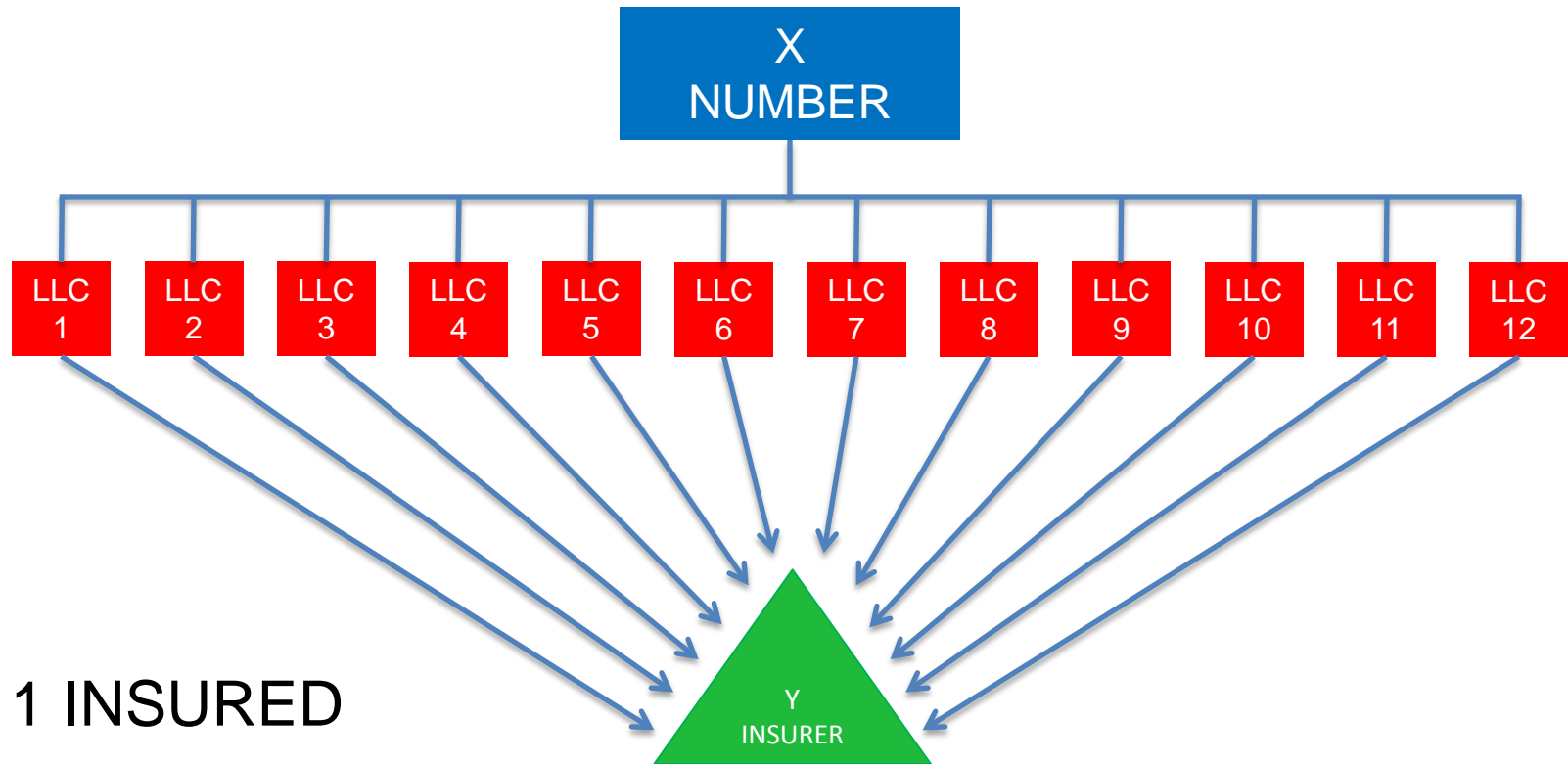
HEALTHMARK GROUP LTD., GREGORY LENTZ A PARTNER OTHER THAN TAX MATTERS PARTNER (DOCKET NO. 8269-14) (HEALTHMARK)

- REV. RUL. 2005-40
  - SINGLE MEMBER LLC DISREGARDED FOR TAX PURPOSES
  - IN RETURNING RISK DISTRIBUTION SINGLE MEMBER IS OWNER OF ASSETS

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## DEDUCTIONS FOR PREMIUMS

REV. RUL 2005-40



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## DEDUCTIONS FOR PREMIUMS

### HEALTHMARK

- STATUS OF SINGLE MEMBER LLC'S REGARDED
  - ILM 1999-30-013 – TAXPAYER PERFORMED SERVICES AND DIRECTED PAYMENT BE MADE TO LLC. IRS WANTED TO FILE A LIEN ON ASSETS OF LLC FOR TAXES OWED BY TAXPAYER. IRS DETERMINED IT COULD NOT BECAUSE UNDER STATE LAW TAXPAYER HAD NO RIGHT TO PROPERTY OWNED BY LLC
  - T.D. 9356 NOTED EMPLOYEES SHOULD BE TREATED AS EMPLOYEES OF AN LLC FOR EMPLOYMENT TAX PURPOSES PARTICULARLY AS A RESULT OF STATE EMPLOYMENT TAX ISSUES



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## DEDUCTIONS FOR PREMIUMS

- TECH. ADV. MEMO 200816029 – IRS DID NOT LOOK THROUGH MULTI-OWNER LLC BASED ON STATE LAW ANALYSIS
- SUZANNE J. PIERRE v. COMMISSIONER, 133 T.C. 24 (2009), TAX COURT TOOK THE POSITION THAT TRANSFERS OF INTERESTS IN AN LLC TREATED AS A DISREGARDED ENTITY TREATED AS SUCH RATHER THAN TRANSFER OF UNDERLYING ASSETS FOR GIFT TAX PURPOSES. SEE ALSO ReRI HOLDINGS INC. v. COMMISSIONER, T.C. MEMO 2014-99 (2014)

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## DEDUCTIONS FOR PREMIUMS

### HEALTHMARK

- **FACTS**
  - IRS HAD DISREGARDED 8 SUBSIDIARIES FORMED AS SINGLE MEMBER LLC'S AND DENIED DEDUCTION FOR PAYMENT TO SISTER CAPTIVE. MARCH 27, 2015 DECISION ENTERED STIPULATING ENTRY OF JUDGMENT PURSUANT TO WHICH ALL DEDUCTIONS ALLOWED

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## AVRAHAMI v. COMMISSIONER

TRIED 3/6/15 IN U.S. TAX COURT (DOCKET NO. 17594-13) IN PHOENIX – AWAITING DECISION

- FACTS
  - T/P CREATED FEEDBACK INS. CO. IN ST. KITTS AND MADE §953(d) ONSHORE TAX ELECTION
  - FEEDBACK FUNDED RISKS OF T/P'S RETAIL JEWELRY AND REAL ESTATE ACTIVITIES, INCLUDING TERRORISM, ADMINISTRATIVE ACTIONS AND BUSINESS RISK INDEMNITY
  - IRS: RISK DISTRIBUTION AND CAPITALIZATION INADEQUATE; MOST POLICIES COVER BUSINESS NOT INSURANCE RISKS; "LOANS" TO T/P NOT BONA FIDE DEBT SO ORDINARY INCOME; PREMIUMS NOT ARM'S-LENGTH AMOUNTS; PROMOTERS SOLD IDEA TO T/P

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## AVRAHAMI v. COMMISSIONER

IRS ALLEGES FEEDBACK JUST A TAX SAVING DEVICE

- NO CLAIMS PAID UNTIL IRS AUDIT COMMENCED
- “PREMIUMS” WERE DEDUCTED AND THEN RECYCLED TO TAXPAYERS AS SHAM LOANS
- NO ECONOMIC SUBSTANCE PLUS STEP TRANSACTION & SUBSTANCE OVER FORM DOCTRINES APPLICABLE
- IRS WHARTON EXPERT: NOT “REAL” INSURANCE
- PENALTIES FOR SUBSTANTIAL UNDERPAYMENT OF TAXES AND NEGLIGENTLY DISREGARDING RULES AND REGULATIONS ARE APPROPRIATE

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## RESIDUAL VALUE AND OTHER INSURANCE RISKS

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## TAM 201149021 – RELEASED 12/9/2011

CONCLUDED POLICY PROVIDING RESIDUAL LEASE VALUE COVERAGE TO A “PROTECTED PARTY” (I.E., POLICYHOLDER) IS NOT AN “INSURANCE” CONTRACT FOR FEDERAL TAX PURPOSES BASED ON A 3-PRONGED IRS RATIONALE:

*ABSENCE OF INSURANCE RISK* – POLICIES PROVIDE PROTECTION AGAINST MARKET FORCES AND GENERALLY NOT AGAINST DAMAGES FROM AN “ACCIDENT” OR “CASUALTY EVENT” SO NO FORTUITY; THEREFORE MUST BE AN INVESTMENT RISK



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## **TAM 201149021 – RELEASED 12/9/2011**

*NOT INSURANCE IN THE COMMONLY ACCEPTED SENSE - COVERAGE EXCLUDED PHYSICAL DAMAGE TO THE LEASED PROPERTY; IRS STATED THE FACT THAT RESIDUAL VALUE INSURANCE IS READILY AVAILABLE COMMERCIALY WAS NOT RELEVANT*

IRS QUOTE: “THE TAX TREATMENT OF A PRODUCT AT ISSUE SHOULD BE DECIDED BY LEGAL RELATIONSHIPS AND NOT BY THE NUMBER OF PRODUCT SELLERS OR THE AMOUNT OF PRODUCT SALES”

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## TAM 201149021 – RELEASED 12/9/2011

*LACK OF RISK DISTRIBUTION* - IRS ALLEGED CONTRACTS IN ISSUE WERE INTERDEPENDENT IN THAT A GENERAL ECONOMIC RECESSION, INCREASE IN UNEMPLOYMENT, JUMP IN FUEL PRICES, ETC. WOULD ADVERSELY IMPACT THE RESIDUAL VALUE OF ALL LEASED PROPERTY (CONSTRUCTION EQUIPMENT, COMPUTERS, MOTOR VEHICLES, ETC.)

- IRS INVOKED THE REASONING BEHIND ITS “FLOOD PLAIN” NO INDEPENDENT / UNCORRELATED RISK REVENUE RULING ISSUED IN 1960

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## **TAM 201149021 – RELEASED 12/9/2011**

- HARD TO ACCEPT GIVEN THOUSANDS OF ITEMS SCATTERED ACROSS THE GLOBE  
OUTCOME COULD IMPACT OTHER IRS ALLEGED BUSINESS RISK COVERAGES OR COULD BE FACT SPECIFIC TO THIS LINE OF COVERAGE

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## **R.V.I. GUARANTY v. COMM'R**

- 145 T.C. No. 9, DECIDED SEPTEMBER 21, 2015
- TAXPAYER TAX COURT WIN IN A NON-CAPTIVE INSURANCE CASE WITH IMPLICATIONS TO THE CAPTIVE INDUSTRY

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## PROCEDURAL BACKGROUND

- TAXPAYER ISSUED “RESIDUAL VALUE INSURANCE” POLICIES – WHICH INSURED AGAINST THE RISK THAT THE VALUE OF THE ASSET AT THE END OF A LEASE WOULD BE LOWER THAN THE EXPECTED VALUE
- IRS CONCLUDED THAT RVI’S POLICIES WERE NOT INSURANCE FOR TAX PURPOSES (PRIMARILY) BECAUSE THE INSUREDS WERE PURCHASING PROTECTION AGAINST AN INVESTMENT RISK, NOT AN INSURANCE RISK

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## FACTUAL BACKGROUND

- INSUREDS INCLUDED LEASING COMPANIES, MANUFACTURERS, AND FINANCIAL INSTITUTIONS (LESSORS OF ASSETS OR PROVIDERS OF LEASE FINANCING)
- ASSET (RISK UNITS) INCLUDED PASSENGER VEHICLES, COMMERCIAL REAL ESTATE, COMMERCIAL EQUIPMENT (OVER TWO MILLION IN TOTAL)
- POLICIES INCLUDED STANDARD TERMINOLOGY AND POLICY PROVISIONS ADAPTED FOR THIS LINE OF COVERAGE



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## FACTUAL BACKGROUND

- TAXPAYER PAID SIGNIFICANT CLAIMS
- POLICIES WERE TREATED AS INSURANCE FOR STATE AND BERMUDA REGULATORY PURPOSES AND RECEIVED “INSURANCE STRENGTH RATINGS” FROM RATING AGENCIES

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## EXPERT TESTIMONY - TAXPAYER

- THREE EXPERTS
- RISKS: POLICIES COVERED AN INSURANCE RISK – SIMILAR TO MORTGAGE GUARANTY INSURANCE
- DISTRIBUTED IN THE SAME WAY AS OTHER P&C COMPANIES
- RISK TRANSFERRED FROM INSURED TO INSURER; TAXPAYER WAS SUBJECT TO UNDERWRITING RISK
- POLICIES CONSISTENTLY TREATED AS INSURANCE UNDER STATUTORY ACCOUNTING PRINCIPLES

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## EXPERT TESTIMONY - IRS

- THREE EXPERTS
- RISKS: POLICIES COVERED A SPECULATIVE RISK – SIMILAR TO A STOCK INVESTMENT (TAXPAYER USE EXPERT'S OWN CITED SOURCES ON THIS POINT AGAINST IRS)
- ADMITS UNDER CROSS-EXAMINATION THAT RISKS WERE DISTRIBUTED, BUT NOTES THAT THEY WERE ALSO HIGHLY CORRELATED
- NO RISK TRANSFER BECAUSE TAXPAYER'S RISK OF LOSS WAS "REMOTE" – MANY POLICIES HAD EXPERIENCED NO LOSSES

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## EXPERT TESTIMONY - IRS

- ON CROSS-EXAMINATION, IRS EXPERT CONCEDES METHODOLOGICAL ERROR AND ACKNOWLEDGES “SIGNIFICANT LOSSES” (SECOND IRS EXPERT MAKES THE SAME MISTAKE!)
- POLICIES DIFFER FROM TYPICAL INSURANCE POLICIES – THEY DON’T INSURE AGAINST A FORTUITOUS EVENT AND INSURER DOESN’T FACE ANY TIMING RISK

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## OPINION – RISK SHIFTING

- INSUREDS TRANSFERRED TO INSURER A “MEANINGFUL RISK OF LOSS”
- MAJOR LOSSES COULD (AND DID) OCCUR
- NOTES IRS EXPERTS’ METHODOLOGICAL ERRORS

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## OPINION – RISK DISTRIBUTION

- INSURER INSURED A VAST ARRAY OF DIFFERENT RISK EXPOSURES; ACHIEVED SUFFICIENT RISK DISTRIBUTION
- IN ONE YEAR – 951 POLICIES COVERING 714 DIFFERENT INSUREDS; OVER TWO MILLION RISK UNITS
- RISKS ALSO DISTRIBUTED ACROSS BUSINESS SEGMENTS, ASSET TYPES, GEOGRAPHIC LOCATIONS AND LEASE DURATIONS



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## OPINION RISK DISTRIBUTION

- OK THAT INSURER FACED SOME SYSTEMATIC RISK AS LONG AS MANY OF THE RISKS IT INSURED AGAINST WERE UNCORRELATED (PERFECTION NOT THE STANDARD)

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## OPINION – COMMON NOTIONS

- ORGANIZED, OPERATED AND REGULATED AS AN INSURANCE COMPANY BY EVERY STATE IN WHICH IT DID BUSINESS
- ADEQUATELY CAPITALIZED
- VALID AND BINDING POLICIES
- CLAIMS FILED, CLAIMS PAID
- PREMIUMS NEGOTIATED AT ARMS' LENGTH

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## OPINION – COMMON NOTIONS

- COURT REBUTS IRS “TIMING” ARGUMENT – OK THAT POLICIES DON’T PAY UNTIL END OF LEASE
- UNIQUE FEATURES OF POLICIES  
“CORRESPOND TO, AND ARE DRIVEN BY, THE CHARACTERISTICS AND BUSINESS NEEDS OF THE UNDERLYING LEASING TRANSACTION.”

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## OPINION – INSURANCE RISK

- ACKNOWLEDGES THAT PRIOR DECISIONS DON'T EXPLAIN DIFFERENCE BETWEEN “INSURANCE RISK” AND “INVESTMENT RISK”
- TO DETERMINE WHETHER INSURANCE RISK, NEED TO EXAMINE FROM THE PERSPECTIVE OF BOTH THE INSURER AND THE INSURED
  - INSURER: AT RISK FOR SIGNIFICANT UNDERWRITING LOSSES THAT WERE NOT RELATED TO ITS INVESTMENT RETURNS
  - INSURED: PURCHASED POLICIES TO PROTECT AGAINST RISK CAUSED BY UNEXPECTED EVENTS

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## OPINION – INSURANCE RISK

- STATES HAVE REGULATED INSURANCE CONTRACTS THAT PROVIDE COVERAGE AGAINST DECLINE IN THE MARKET VALUE OF ASSETS FOR OVER 80 YEARS
- VALUE OF ASSETS “MAY BE ADVERSELY AFFECTED BY FORTUITOUS EVENTS SPECIFIC TO THE PARTICULAR PROPERTY”

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**ILM 201511021**

## **FX RISK NOT INSURANCE**

- CCA CONCLUDED MULTINATIONAL'S FUNDING FOREIGN CURRENCY FLUCTUATION "LOSS OF EARNINGS" RISK IN ITS DOMESTIC CAPTIVE IS NOT INSURANCE FOR TAX PURPOSES
- CONTRACT #1: FIX RATE CHANGE NOT "A CASUALTY EVENT IN THE COMMONLY ACCEPTED SENSE" SO NO INSURANCE CONTRACT
- CONTRACT #2: INSUFFICIENT RISK DISTRIBUTION UNDER REASONING OF REV. RUL. 2005-40



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**ILM 201511021**

## **FX RISK NOT INSURANCE**

- CCA SAYS INVESTMENT RISK AND BUSINESS RISK ARE “PERHAPS SYNONYMOUS” TERMS
- IRS HINTS THIS NON-INSURANCE TRANSACTION MIGHT PROPERLY BE TAXED AS A DERIVATIVE CURRENCY SWAP
- TIMING OF ISSUANCE MIGHT BE TO BOLSTER IRS ARGUMENTS IN ITS RVI BRIEF

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## **SAMPLE LINES OF COVERAGE POTENTIALLY IMPACTED BY THE RVI DECISION**

TRADE CREDIT RISK

SUPPLY CHAIN RISK

REPUTATIONAL/BRAND/LOSS OF INCOME RISKS

INTELLECTUAL PROPERTY (E.G., PATENT TROLL INSURANCE)

LONGEVITY RISK (PENSION PLANS AND ANNUITY ISSUERS)

LOSS OF KEY CUSTOMER

MERGER & ACQUISITION TRANSACTIONAL REP & WARRANTY BREACH

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## **SAMPLE LINES OF COVERAGE POTENTIALLY IMPACTED BY THE RVI DECISION**

CHARITABLE EVENT “HOLE-IN-ONE” PRIZE  
INSURANCE

HOUSING MARKET/HOME EQUITY DECLINE AT  
TIME OF SALE AT A LOSS

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## MEDICAL STOP LOSS

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## MEDICAL STOP LOSS

### BACKGROUND

- PROGRAMS GENERALLY DESIGNED TO REIMBURSE EMPLOYERS WITH REGARD TO LOSS ASSOCIATED WITH SELF-INSURED PROGRAMS
- STATE MINIMUM PER INDIVIDUAL AND AGGREGATE ATTACHMENT POINTS
- STRUCTURED GENERALLY TO AVOID “PLAN” STATUS UNDER ERISA PER ADVISORY OPINION 92-02A, REIMBURSEMENT SOLELY TO THE EMPLOYER

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## MEDICAL STOP LOSS

### RELATED OR UNRELATED BUSINESS

- REV. RUL 92-93
- REV. RUL 92-94
- REV. RUL 2014-15

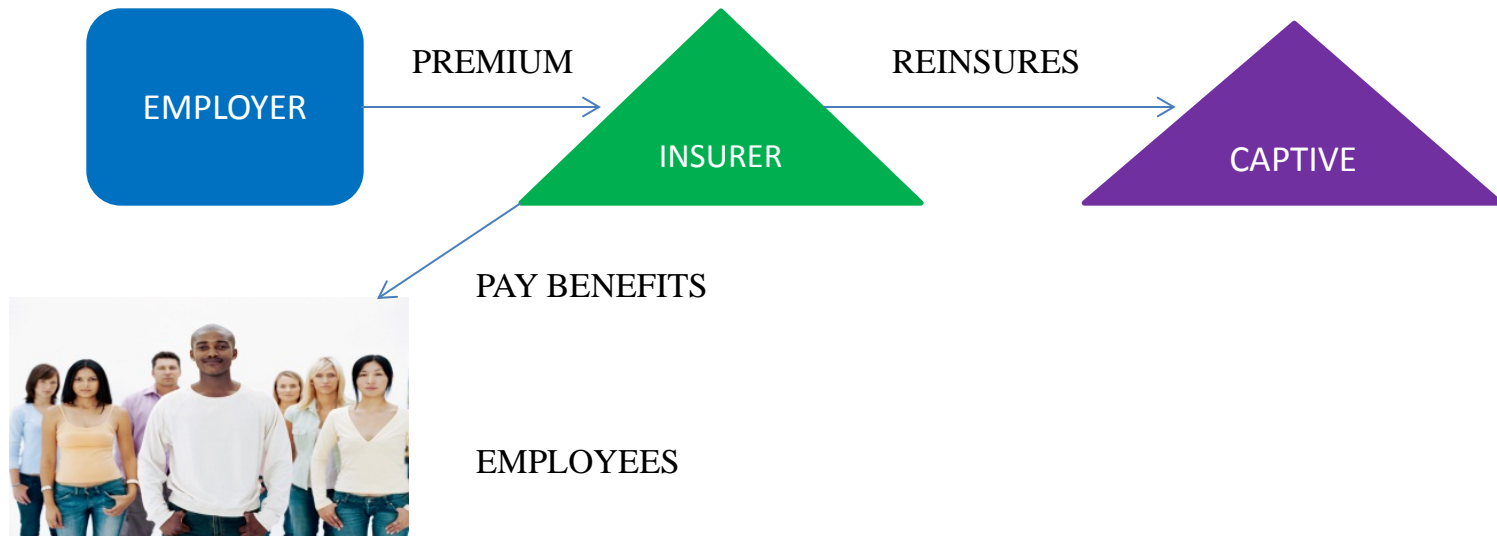


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## MEDICAL STOP LOSS

### BACKGROUND

- IRS HAS TAKEN THE POSITION THAT SUCH INSURED BENEFITS ARE EMPLOYEE NOT EMPLOYER RISKS, *SEE* REV. RUL. 92-93

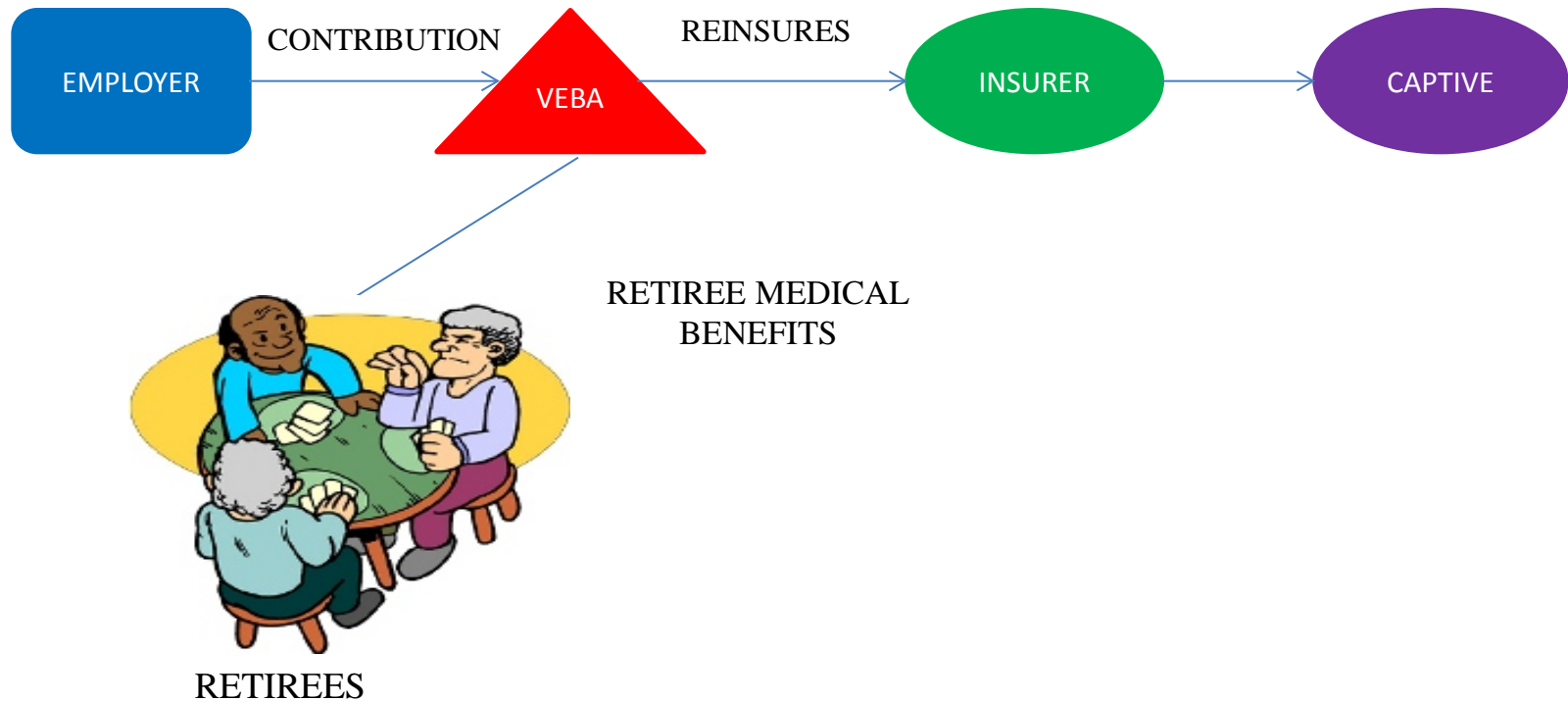


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## MEDICAL STOP LOSS

REV. RUL. 2014-15

- FACTS



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## MEDICAL STOP LOSS

RELATED OR UNRELATED BUSINESS

- IS IRS POSITION TO LOOK THROUGH TO EMPLOYEES/RETIREES BASED ON CONTRACTUAL RELATIONSHIP BETWEEN INSURED AND ISSUER OF CERTIFICATE

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## MEDICAL STOP LOSS

### CONSEQUENCES

- ANALYZE YOUR PROGRAM AND DETERMINE WHETHER IT WILL BE ADVERSELY AFFECTED IF MEDICAL STOP LOSS ADDED AND IT IS TREATED AS RELATED BUSINESS
  - PREMIUMS PAID TO CAPTIVE DEDUCTIBLE BASED ON HUMANA ANALYSIS, SIMILAR SPREAD ON MEDICAL STOP LOSS
  - PREMIUMS PAID TO CAPTIVE NOT DEDUCTIBLE BASED ON HUMANA UNLESS RENT-A-CENTER/SECURITAS ANALYSIS APPLIES
  - PREMIUMS PAID, *e.g.*, ONLY FOR PARENT RISK, AND DEDUCTION BASED ON UNRELATED BUSINESS

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## **ACTIVITY RELATING TO CAPTIVES MAKING A SECTION 831(b) ELECTION AND THEIR AGGREGATORS**

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## IRC §831(b) CAPTIVES

ELIGIBLE (DOMESTIC OR §953(d)) P&C INSURANCE COMPANIES GENERATING ANNUAL WRITTEN PREMIUMS OF \$1.2 MILLION OR LESS

IRC §831(b) IS A FEDERAL INCOME TAX ELECTION THAT CANNOT BE REVOKED EXCEPT WITH CONSENT OF TREASURY SECRETARY

§831(b) CAPTIVE IS TAXED ONLY ON ITS INVESTMENT INCOME; UNDERWRITING PROFITS ACCUMULATE ON A TAX-DEFERRED BASIS, POTENTIALLY FOR LONG PERIOD FOR LONG-TAIL INSURANCE RISKS



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## IRC §831(b) CAPTIVES

DISADVANTAGES: INABILITY TO USE UNDERWRITING LOSSES TO OFFSET INVESTMENT INCOME OR TO CARRY LOSSES FORWARD OR BACKWARD

STATE CAPTIVE INSURANCE LAWS AND MANY CAPTIVE REGULATORS DON'T RECOGNIZE §831(b) CAPTIVE INSURERS AS A DISTINCT CATEGORY MUST MEET TAX DEFINITION OF AN INSURANCE COMPANY (LIKE ANY CAPTIVE INSURER) TO DEDUCT PREMIUMS PAID BY INSUREDS

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## IRC §831(b) CAPTIVES

GENERALLY COVER HIGH SEVERITY, LOW FREQUENCY LOSS EXPOSURES

HEAVY PROMOTION TO FAMILY BUSINESSES BY HIGH NET WORTH WEALTH PLANNERS, ACCOUNTING AND LEGAL PROFESSIONALS FOR TAX BENEFITS SO IRS IS NOW CONCENTRATING ON AUDITING BOTH

§831(b) CAPTIVES & AGGREGATORS

§831(b) CAPTIVES ALSO KNOWN AS “MICRO-CAPTIVES”

# NAVIGATING TO SUCCESS

## TAX SHELTER PROMOTER INVESTIGATIONS

THE IRS HAS OPENED TAX SHELTER PROMOTER INVESTIGATIONS OF SEVERAL §831(b) AGGREGATORS, THE RISK POOLS THEY SPONSOR, AS WELL AS AUDITING THE PARTICIPATING FAMILY BUSINESSES

THE BATTLE IS ONGOING WITH ULTIMATE RESULTS UNPREDICTABLE

IRS HAS PREVAILED IN COURT PROCEEDING THAT THE TAXPAYER MUST COMPLY WITH ONEROUS IDRs (INFORMATION DOCUMENT REQUESTS)

# NAVIGATING TO SUCCESS

## TAX SHELTER PROMOTER INVESTIGATIONS

IDRs USUALLY ASK FOR DETAILED INFORMATION FROM INCEPTION OF THE CAPTIVE ARRANGEMENT (EVEN IF IT PREDATES THE YEARS IN ISSUE)

TYPICAL REQUEST IS FOR ALL EMAILS, DOCUMENTS, BROCHURES, ETC. BUT TAXPAYER CAN TRY TO NARROW BY USING AN EXTENSIVE LIST OF APPROPRIATE SEARCH TERMS

OFTEN A FOCUS ON NON-TAX MOTIVATION FOR CAPTIVE AND THE USUAL TAX TESTS: INSURANCE RISK, RISK SHIFTING, RISK DISTRIBUTION AND COMMON NOTIONS OF INSURANCE

# NAVIGATING TO SUCCESS

## IR 2015-19

THE IRS ANNUALLY ISSUES WARNINGS TO TAXPAYERS ABOUT ABUSES SUCH AS IDENTITY THEFT, PHISHING, TAX SCAMS, ETC. (KNOWN AS THE “DIRTY DOZEN”)

IR 2015-19, FOR THE FIRST TIME, REFERENCES CAPTIVES ELECTING §831(b) WITH “TAX SHELTERS”

IRS ADMITS A CAPTIVE ELECTING §831(b) CAN BE A LEGITIMATE TAX STRUCTURE

# NAVIGATING TO SUCCESS

## **IR 2015-19 831(b) AND TAX SHELTERS**

IRS STATED UNSCRUPULOUS PROMOTERS  
DESIGNED STRUCTURES TO CREATE SCHEMES  
WITH POORLY DRAFTED POLICIES COVERING  
BUSINESS AND ESOTERIC, IMPLAUSIBLE RISKS  
FOR EXORBITANT PREMIUMS

IT NOTED THAT ACTUARIAL SUBSTANTIATION  
BACKING INSURANCE PREMIUMS WAS MISSING  
OR INSUFFICIENT

PLUS PROMOTERS MAKE HEFTY FEES WHILE  
CONVINCING UNSOPHISTICATED TAXPAYERS TO  
CONTINUE THE “CHARADE”



# NAVIGATING TO SUCCESS

## SENATE FINANCE COMMITTEE §831(b) PROPOSALS

ON 2/9/15 THE JOINT COMMITTEE ON TAXATION SUMMARIZED A PROPOSED §831(b) BILL THAT WOULD:

- INCREASE MAXIMUM PREMIUMS FROM \$1.2 TO \$2.2M
- TO QUALIFY, THERE MUST BE 80% UNRELATED BUSINESS
- TO QUALIFY, THE CAPTIVE COULD ONLY WRITE DIRECT BUSINESS (*i.e.*, COULD NOT BE A REINSURER)

# NAVIGATING TO SUCCESS

## SENATE FINANCE COMMITTEE §831(b) PROPOSALS

THE PROPOSAL WAS AMENDED TO CONTAIN ONLY THE INCREASE IN THE MAXIMUM PREMIUM LEVEL THE TREASURY ASKED TO PREPARE A REPORT ON ESTATE PLANNING ABUSES INVOLVING §831(b) TO REDUCE REVENUE LOSS THE SFC LIKELY WILL REQUIRE THE IRS TO PROPOSE RESTRICTIONS ON ELIGIBILITY TO MAKE A §831(b) ELECTION

# NAVIGATING TO SUCCESS

## DIRECT PROCUREMENT TAX

# NAVIGATING TO SUCCESS

## DIRECT PROCUREMENT TAX

DIRECT PLACEMENT TAX IS IMPOSED ON AN INSURED WHEN DIRECTLY PROCURING COVERAGE FROM A NON-ADMITTED INSURER (*i.e.*, CAPTIVE)

PAYABLE BASED ON RATES, VARYING BY STATES ON THE NET WRITTEN PREMIUMS PAID TO THE CAPTIVE

NOTE, SOME STATES DO NOT IMPOSE ANY DIRECT PLACEMENT TAX

# NAVIGATING TO SUCCESS

## DIRECT PLACEMENT TAX - ILLINOIS

EFFECTIVE JANUARY 1, 2015, S.B. 3324 IMPOSED DIRECT PLACEMENT TAX OF UP TO 4.6% ON INSURANCE CONTRACTS INDEPENDENTLY PROCURED FROM A NON-ADMITTED INSURER BY INDUSTRIAL INSUREDS

- INDUSTRIAL INSUREDS ARE DEFINED AS THOSE WHO,
  - PROCURE THE INSURANCE OF CLASS 2 (CASUALTY, FIDELITY, SURETY), OR CLASS 3 (FIRE AND MARINE) RISKS BY USE OF SERVICES OF A FULL-TIME EMPLOYEE WHO IS A QUALIFIED RISK MANAGER

# NAVIGATING TO SUCCESS

## DIRECT PLACEMENT TAX - ILLINOIS

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# NAVIGATING TO SUCCESS

## DIRECT PLACEMENT TAX - ILLINOIS

- PROCURES INSURANCE FROM AN UNAUTHORIZED INSURER WITHOUT SERVICES OF AN INTERMEDIARY INSURANCE PRODUCER, AND
- IS AN EXEMPT COMMERCIAL PURCHASER WHOSE HOME STATE (GENERALLY THE PRINCIPAL PLACE OF BUSINESS) IS ILLINOIS

# NAVIGATING TO SUCCESS

## **DIRECT PLACEMENT TAX - TENNESSEE**

LEGISLATIVELY AMENDED ITS DIRECT PLACEMENT TAX ON NON-ADMITTED INSURANCE

PREVIOUSLY TENNESSEE HAD ONLY IMPOSED DIRECT PLACEMENT TAXES ON LIMITED LINES OF BUSINESS SUCH AS MARINE INSURANCE

SECTION 56-2-411 OF THE TENNESSEE CODE ANNOTATED EXPANDS ITS DIRECT PLACEMENT TAX BEYOND MARINE INSURANCE TO INDUSTRIAL INSUREDS, AS SIMILARLY DEFINED

# NAVIGATING TO SUCCESS

## DIRECT PLACEMENT TAX

PROPOSED LEGISLATION

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

### VALIDUS

- FEDERAL EXCISE TAX, IN GENERAL, DUE AT 4% ON DIRECT AND 1% ON REINSURANCE OF US RISKS BY US PERSON TO FOREIGN PERSON
- IN 2008, IRS ISSUED REV. RUL. 2008-15 INDICATING THAT TAX CASCADED
- VALIDUS, A BERMUDA COMPANY, ENTERED INTO A NUMBER OF RETROCESSIONS WHICH IRS CLAIMED WERE SUBJECT TO FET
- VALIDUS PAID THE TAX AND SUED FOR REFUNDS IN US DISTRICT COURT FOR DISTRICT OF COLUMBIA

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

- DC COURT HELD FOR VALIDUS TAKING POSITION THAT UNDER PLAIN LANGUAGE OF THE STATUTE IT DID NOT APPLY TO RETROCESSIONS
- IRS APPEALED
- ANAMOLIES ARISING FROM DECISION
  - RETROCESSION BY US REINSURER TO FOREIGN REINSURER
  - REINSURANCE BY FOREIGN DIRECT WRITER



# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

- US COURT OF APPEALS FOR DC CONCLUDED STATUTE “IS AMBIGUOUS TO WHOLLY FOREIGN RETROCESSIONS”
- APPLIED A PRESUMPTION AGAINST EXTRATERRITORIAL APPLICATION CONCLUDING TAX DOES NOT APPLY TO RETROCESSIONS BETWEEN TWO FOREIGN CORPORATIONS (THE FACTS BEFORE THE COURT)
- [APPEAL] APPLICATION GOING FORWARD
  - FILES RETURNS (?)
  - FOREIGN REINSURANCE (?)

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

### PASSIVE FOREIGN INVESTMENT COMPANIES (PFIC)

- EXISTING STATUTE PROVIDES “PENALTY” TAX REGIME TO PFIC SHAREHOLDERS
  - GAINS AND CERTAIN DIVIDENDS TAXED BASED ON “THROWBACK” AT ORDINARY INCOME TAX RATES
  - ADDITIONAL CHARGE APPLIED TO EACH YEAR’S ALLOCABLE TAX
- TEST
  - 75% OR > OF GROSS INCOME PASSIVE, OR
  - ON AVERAGE 50% OR > OF ASSETS HELD TO PRODUCE PASSIVE INCOME

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

- EXCEPTIONS
  - THE STATUTE PROVIDES AN EXCEPTION TO THE PASSIVE INCOME DEFINITION FOR “INCOME DERIVED IN THE ACTIVE CONDUCT OF AN INSURANCE BUSINESS BY A CORPORATION WHICH IS PREDOMINATELY ENGAGED IN AN INSURANCE BUSINESS AND WHICH WOULD BE SUBJECT TO TAX AS AN INSURANCE COMPANY IF SUCH COMPANY WERE A DOMESTIC COMPANY”

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

- NOT APPLICABLE TO CONTROLLED FOREIGN CORPORATION 10% SHAREHOLDER – SO SINGLE PARENT CAPTIVES ARE EXCLUDED
- NOT CLEAR WITH REGARD TO REPP CFC – BUT LIKELY NO PURPOSE
- AGENCY CAPTIVES NOT CFC'S
- CAPTIVE TO CAPTIVE UNRELATED BUSINESS NOT CFC'S

## FOREIGN CAPTIVE ISSUES

- PROPOSED REGULATIONS
  - THE PROPOSED REGULATIONS PROVIDED THAT (I) PASSIVE INCOME DOES NOT INCLUDE INCOME EARNED BY A FOREIGN COMPANY THAT WOULD QUALIFY AS A DOMESTIC INSURANCE COMPANY, IF SUCH COMPANY WERE A DOMESTIC COMPANY, AND (II) THE INCOME IS DERIVED IN AN ACTIVE CONDUCT OF AN INSURANCE BUSINESS
  - THE TERM “ACTIVE CONDUCT” MEANS THE COMPANY’S OFFICERS AND EMPLOYEES CARRY OUT SUBSTANTIAL MANAGERIAL AND OPERATIONAL ACTIVITIES

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

- A COMPANY CAN BE ENGAGED IN AN ACTIVE TRADE OR BUSINESS IF INCIDENTAL ACTIVITIES ARE CARRIED OUT BY INDEPENDENT CONTRACTORS; HOWEVER, IN DETERMINING WHETHER THE OFFICERS OR EMPLOYEES CARRY OUT SUBSTANTIAL MANAGERIAL AND OPERATIONAL ACTIVITIES, THE ACTIVITIES OF THE INDEPENDENT CONTRACTORS ARE DISREGARDED



## FOREIGN CAPTIVE ISSUES

- THE TERM “INSURANCE BUSINESS” MEANS THE BUSINESS OF ISSUING INSURANCE AND ANNUITY CONTRACTS AND THE REINSURING OF RISKS UNDERWRITTEN BY INSURANCE COMPANIES TOGETHER WITH INVESTMENT ACTIVITIES AND ADMINISTRATIVE SERVICES REQUIRED TO SUPPORT THE INSURANCE BUSINESS. THE INVESTMENT ACTIVITIES ARE TO PRODUCE INCOME TO MEET THE INSURANCE OBLIGATIONS
- NEED FOR MANAGERIAL EMPLOYEES
- “SUBSTANTIAL” ACTIVITIES

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

- WYDEN PROPOSAL JUNE 25, 2015

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

### QUALIFYING INSURANCE CORPORATION

- FOR PURPOSES OF THE PROPOSAL, A QUALIFYING INSURANCE CORPORATION IS, FOR ANY TAXABLE YEAR, A FOREIGN CORPORATION:
  - THAT WOULD BE SUBJECT TO TAX UNDER SUBCHAPTER L IF IT WERE A DOMESTIC CORPORATION; **AND**
  - THE “**APPLICABLE INSURANCE LIABILITIES**” OF WHICH CONSTITUTE **MORE THAN 25%** OF ITS TOTAL ASSETS, DETERMINED ON THE BASIS OF SUCH LIABILITIES AND ASSETS AS REPORTED ON THE CORPORATION’S “**APPLICABLE FINANCIAL STATEMENT**” FOR THE YEAR

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

### APPLICABLE INSURANCE LIABILITIES

- FOR PURPOSES OF THE PROPOSAL, APPLICABLE INSURANCE LIABILITIES MEANS, WITH RESPECT TO ANY “LIFE OR PROPERTY AND CASUALTY INSURANCE BUSINESS”:
  - LOSS AND LOSS ADJUSTMENT EXPENSES; **AND**
  - RESERVES (OTHER THAN DEFICIENCY, CONTINGENCY, OR UNEARNED PREMIUM RESERVES) FOR LIFE AND HEALTH INSURANCE RISK AND LIFE AND HEALTH INSURANCE CLAIMS WITH RESPECT TO CONTRACTS PROVIDING COVERAGE FOR MORTALITY OR MORBIDITY RISKS

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

- LIMITATION: ANY AMOUNT DETERMINED UNDER THE TWO PRECEDING POINTS MAY NOT EXCEED THE LESSER OF SUCH AMOUNT:
  - AS REPORTED IN THE APPLICABLE FINANCIAL STATEMENT (OR, IF LESS, THE AMOUNT REQUIRED BY APPLICABLE LAW OR REGULATION); OR
  - AS DETERMINED UNDER TREASURY REGULATIONS
- **NOTE:** NO DEFINITION PROVIDED FOR “LIFE OR PROPERTY AND CASUALTY INSURANCE BUSINESS”

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

### APPLICABLE FINANCIAL STATEMENT

- FOR PURPOSES OF THE PROPOSAL, AN APPLICABLE FINANCIAL STATEMENT IS A STATEMENT FOR FINANCIAL REPORTING PURPOSES THAT:
  - IS MADE ON THE BASIS OF GAAP;
  - IF NO GAAP STATEMENT IS AVAILABLE, IS MADE ON THE BASIS OF IFRS; **OR**
  - IF NO GAAP OR IFRS STATEMENT IS AVAILABLE, AND EXCEPT AS OTHERWISE PROVIDED IN TREASURY REGULATIONS, IS THE ANNUAL STATEMENT REQUIRED TO BE FILED WITH THE “**APPLICABLE INSURANCE REGULATORY BODY**”



# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

### APPLICABLE INSURANCE REGULATORY BODY

- FOR PURPOSES OF THE PROPOSAL, AN APPLICABLE INSURANCE REGULATORY BODY IS, WITH RESPECT TO ANY INSURANCE BUSINESS, THE ENTITY:
  - ESTABLISHED BY LAW TO LICENSE, AUTHORIZE, OR REGULATE SUCH BUSINESS; AND
  - TO WHICH THE APPLICABLE FINANCIAL STATEMENT IS PROVIDED

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

### ALTERNATE FACTS AND CIRCUMSTANCES TEST

- IF A FOREIGN CORPORATION FAILS TO QUALIFY AS A QUALIFYING INSURANCE CORPORATION SOLELY BECAUSE THE APPLICABLE INSURANCE LIABILITIES OF THE CORPORATION CONSTITUTE 25% OR LESS OF ITS TOTAL ASSETS, A U.S. PERSON THAT OWNS STOCK IN SUCH CORPORATION MAY ELECT TO TREAT SUCH STOCK AS TOCK OF A QUALIFYING INSURANCE CORPORATION IF:

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

- THE APPLICABLE INSURANCE LIABILITIES OF THE FOREIGN CORPORATION CONSTITUTE AT LEAST 10% OF ITS TOTAL ASSETS; AND
- UNDER TREASURY REGULATIONS, BASED ON THE “APPLICABLE FACTS AND CIRCUMSTANCES”:
  - THE CORPORATION IS PREDOMINANTLY ENGAGED IN AN INSURANCE BUSINESS; AND
  - SUCH FAILURE IS DUE SOLELY TO “TEMPORARY CIRCUMSTANCES” INVOLVING SUCH INSURANCE BUSINESS

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

### COMMENTS ON FACTS AND CIRCUMSTANCES TEST

- UNCLEAR HOW THIS TEST APPLIES IN THE CONTEXT OF A CORPORATE GROUP WITH LOWER-TIER INSURANCE COMPANY SUBSIDIARIES, PARTICULARLY IN CONJUNCTION WITH APPLICATION OF LOOK-THRU RULE UNDER IRC § 1297(c)

# NAVIGATING TO SUCCESS

## FOREIGN CAPTIVE ISSUES

- THE “FACTS AND CIRCUMSTANCES” PORTION OF THE TEST LIKELY IS NOT MEANT TO BE EFFECTIVE IN THE ABSENCE OF TREASURY REGULATIONS
  - NO INDICATION OF WHAT THE “APPLICABLE FACTS AND CIRCUMSTANCES” MIGHT TAKE INTO ACCOUNT
  - ALSO, UNCLEAR WHAT IS MEANT BY THE FAILURE BEING CAUSED BY “TEMPORARY CIRCUMSTANCES”