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Proposed Regulations Would Deny Reserve Deductions for Certain Captives

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On Sept. 27, 2007, the Internal Revenue Service (IRS) and the Treasury Department (Treasury) issued proposed regulations under Internal Revenue Code (Code) section 1502 related to consolidated group intercompany insurance transactions. The proposed rules would technically still require certain domestic captive insurance companies to be taxed under subchapter L of the Code, but would effectively take away their current deductions for loss reserves and unearned premium reserves. The proposed regulations affect captive insurance companies who are members of consolidated groups and insure the risks of their fellow members. This rule would not apply to captive insurance companies whose members' insurance premiums are less than five percent of all insurance premiums written during the taxable year. In addition, the proposed regulations do not appear to apply with respect to nonmember underwriting risks.

This release was unexpected given the case law and other more recent pronouncements by the IRS and Treasury respecting captive insurance arrangements that would now seem to fall within the guidelines of these proposed regulations. It is also interesting that the attack on captive arrangements has come by way of the regulations on intercompany transactions rather than a direct attack on captives themselves. Taxpayers currently with captive insurance arrangements should remember, however, that these regulations are only PROPOSED and, as a result, do not have the authority of temporary or final regulations.

These proposed regulations would apply to intercompany insurance transactions occurring in consolidated return years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. The official period for comments and requests for a public hearing ended on Dec. 27, 2007.

The Proposed Regulations

The proposed regulations impose single entity treatment on insurance and reinsurance transactions "where a significant amount of the insuring member's business arises from transactions with other group members." The captive insurance company would be considered a "significant insurance member," defined under proposed Treasury regulation section 1.1502-13(e)(2)(ii)(C)(2)(i), "if it is an insurance company subject to tax under subchapter L and five percent or more of the member's insurance premiums written during the taxable year arise from insuring risks of other [brother-sister] members of the group."

By imposing single entity treatment, the insurance arrangement between the significant insurance member and the other members of the group would be treated as "self-insurance" by a single corporation.

Pursuant to proposed Treasury regulation section 1.1502-13(e)(2)(ii)(C)(1):

> [T]he timing and attributes of items from a premium payment from an insured member to a significant insurance member will be taken into account under the matching and acceleration rules, and the premiums earned with respect to the intercompany payment will not be accounted for by the significant insurance member under the rules of section 832(b)(4) [for premiums earned]. The significant insurance member's deduction for losses incurred with respect to the intercompany insurance will be taken into account under the rules of sections 162 and 461 (including section 1.461-2), rather than section 832(b)(5) [for losses incurred].

These proposed intercompany insurance regulations would not apply to the risks of a nonmember, even if the significant insurance member assumes all or a portion of the risk on an insurance contract written by another member with respect to risks of a nonmember. The

significant insurance member would be permitted to "increase its reserve item under section 807(c) or 832(b)(5) with respect to the premium payment" related to the nonmember risks.

Captives: A Historical Perspective

Historically, the IRS and Treasury have challenged the validity of captive insurance arrangements as true insurance, using an "economic family" argument to contend that risk shifting cannot exist. (*See e.g.*, Revenue Ruling 77-316.) Except in cases where the insurance arrangement included the parent company purchasing insurance from its captive insurer subsidiary, however, the economic family argument has been repeatedly rejected by the courts. Captive insurance arrangements generally have been respected by the courts when the transaction involved brother-sister insureds. (*See e.g.*, *Humana*[1] and its progeny.)

After a series of losses with respect to brother-sister captive cases, the IRS and Treasury explicitly abandoned an economic family argument in Revenue Ruling 2001-31. In this ruling, they acknowledged that the courts had not accepted the economic family argument and stated that the "IRS will no longer invoke the economic family theory with respect to captive insurance transactions."

In 2002, the IRS and Treasury issued Revenue Rulings 2002-89 and 2002-90 which contained various examples of valid captive insurance arrangements. The proposed intercompany insurance regulations, however, would have the effect of treating some of these otherwise valid insurance arrangements as self insurance transactions for federal income tax purposes.

The proposed regulations also reflect a change from the current regulations under section 1.1502-13(e)(2)(ii)(A) which specifically require separate entity treatment for insurance transactions between members of the same consolidated group. The preamble to the 1994 regulations address why single entity treatment, as would be required under the new proposed regulations, is not appropriate and separate entity treatment should be applied:

> Reserve accounting is permitted only for special status members, and it is inappropriate to apply some aspects of reserve accounting on a single entity basis (*e.g.*, where both parties to an intercompany transaction do not have the same special status) … [I]f a member provides insurance to another member in an intercompany transaction, the transaction is taken into account by both members on a separate entity basis.

The proposed intercompany insurance regulations, however, would have the effect of treating some of these otherwise valid insurance arrangements as self insurance transactions for federal income tax purposes.

In the new proposed regulations, the IRS and Treasury explain that their departure from the current regulations is due to the former belief that "such [intercompany insurance] transactions would not have a substantial effect on consolidated taxable income, and therefore, it was appropriate to except these transactions from single entity treatment." Later in the preamble to the proposed regulations, the IRS and Treasury state their current belief that the "increasing prevalence of captive insurance arrangements within consolidated groups," and the separate entity treatment "may now have a greater effect on consolidated taxable income than was anticipated when the Current Regulations were issued." It is not clear from the preamble, however, whether the concern was simply that more taxpayers are entering into transactions that fall within the subchapter L rules, or that such transactions will have a "greater effect on consolidated income" in any individual case.

As such, the recently proposed regulations disallow the provisions of subchapter L with respect to intercompany insurance transactions. They specifically provide that sections 162 and 461 will apply rather than section 832 to loss reserve deductions. The proposed regulations, therefore, seem to imply that sections 162 and 461and the matching and acceleration rules have not applied to captive insurance companies in the past. The fact of the matter is that sections 162 and 461 have always applied to insurance companies but Congress has specifically

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[1] *Humana Inc. v. Commissioner,* 88 T.C. 197 (1987), *aff'd in part, rev'd in part,* 881 F.2d 247 (6th Cir. 1989).

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provided that the timing of the deductibility of loss reserves is governed by subchapter L.

Another item that merits further consideration with respect to the proposed regulations relates to unearned premium reserves. For example, the proposed regulations provide that member insurers of consolidated groups lose their current deductions for unearned premium reserves.

For the typical one-year policy issued by many captive insurance companies, the deduction of the premium by the insured members of the consolidated group and the premiums earned by the captive member are matched and the question of an unearned premium reserve is moot. A situation involving a multi-year insurance policy, however, could potentially lead to some mismatch of income and deduction within a consolidated group if the insured were to take a deduction for the full premium when paid at the same time that the captive insurer includes in income only a portion of the amount received because of the limitation on the deduction of the unearned premium reserve. The IRS, however, can rely on section 263 to enforce any inappropriate mismatch of deduction and income and, in the case of reinsurance transactions, it can turn to section 845. A change to the intercompany insurance regulations is not necessary.

What Happens Next?

Approximately 10 years ago, there was a legislative proposal targeting captive insurance arrangements and the lobbying effort against it was strong. Currently, there are 26 states with captive insurance company legislation which make captives a significant revenue raiser for those states. As one would expect, a significant effort is being undertaken by the states and captive insurance industry providers this time around as well.

Should the proposed regulations be finalized in their current form, the regulation would not apply to the intercompany insurance transactions that occurred prior to the effective date. In other words, "self insurance" treatment would only apply to the premiums and loss reserves established in consolidated return years on or after the final regulations are published in the Federal Register. It is interesting that the government maintains that captive insurance companies in consolidated groups are still insurance companies for federal tax purposes even though their reserve deductions no longer exist with respect to business written on the risks of their members.

Many taxpayers with captive insurers within their consolidated groups are rightfully concerned about their arrangements. Some are considering restructuring their consolidated group while others contemplate an offshore captive. It would seem, however, that any action of this type may be premature. The proposed regulations are simply that. They are proposed. That being said, all taxpayers with captive insurance companies in their consolidated groups should pay close attention to the debate over these regulations and consider whether and how it still may be possible to participate in the discussion.