

## Frequently Asked Questions

about the

### Proposed IRS Regulation

On

### Insurance between Members of a Consolidated Group (Captive Insurance Companies)

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*Please note that the following statements are to be read as the observations of experienced captive insurance tax professionals, but do not constitute and should not be construed to be tax or legal advice and cannot be used to avoid tax penalties. Interested taxpayers should consult their own tax advisers on application and consequences of this proposed regulation to their particular factual circumstances.*

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#### **What captives are affected?**

The proposed regulation would affect domestic captives (including foreign captives which have elected, pursuant to Section 953(d), to be treated as domestic for US tax purposes) which are a part of the same consolidated tax return group as the premium payer. In order for a captive to be included in a consolidated tax return, the domestic parent must own 80% or more (vote and value) of the domestic (or electing foreign) captive.

#### **What captives are not affected?**

- Foreign captives (which have not elected to be treated as domestic for US tax purposes) and domestic captives (including foreign captives which have elected to be treated as domestic for US tax purposes) which are not a part of the same US consolidated tax return group as the premium payer.
- Group captives and risk retention groups (RRGs) will generally not be affected.
- Captives writing 95% unrelated business will not be affected.

#### **What are the ramifications of the proposed regulation?**

The proposed regulation would defer the tax deduction for an incurred loss arising from related party business until it is actually paid (i.e., no deduction for discounted loss reserves as currently available). This change would essentially result in treating the transaction as non-insurance for tax purposes.

#### **What will happen to existing single parent captives?**

The proposed regulation would affect both new and existing captives equally. As currently written the regulation would apply to all transactions entered into in tax years beginning on or after the regulation is published in final form. Existing related party discounted reserves at the effective date of this regulation will remain deductible as reserves until the corresponding claims are paid.

## **How much will it cost an existing single parent captive?**

The cost to captives depends on both the lines of business written and whether (and how) the taxpayer decides to restructure. **The effect of the regulation is to defer the deduction for losses until they are actually paid, so the tax detriment is the present value of the difference between a current deduction for discounted loss reserves and a future deduction for paid claims.**

## **What kinds of coverages are negatively affected?**

The proposed regulation affects all coverages. The longer the tail on the business, the greater the adverse tax impact will be. Examples of long-tail coverages are medical malpractice, products liability and workers' compensation. An example of short-tail coverage is property coverage (fire, windstorm, etc.).

## **How does this upset the current playing field?**

All owners of domestic (and electing foreign) captives that are a part of the same consolidated tax return will be negatively affected. The proposed regulation may result in foreign captives being more attractive than domestic captives to some taxpayers.

## **What are the negative policy ramifications of the proposed regulation?**

The proposed regulation has a number of negative policy implications.

- It effectively overrides the insurance tax treatment afforded to properly structured captive insurance transactions by the Courts for decades, and by the IRS in Revenue Rulings. While the IRS has broad power to issue legislative regulations in the consolidated return area, that power was never intended to allow the IRS to effectively write its own version of the Internal Revenue Code for filers of consolidated returns. If the proposed regulation is enacted, that will be a precedent for the IRS to override Court decisions and legislation it dislikes, to the extent the taxpayers involved are within a consolidated tax return group. Essentially, the IRS has assumed the power to make law. This surely would not be the intention of the Congressional grant of regulatory power in the consolidated return area.
- The IRS action is particularly troubling here, where the IRS has not shown, or even alleged, that there is abuse of the consolidated return rules (such as a double deduction or acceleration of a deduction or deferral of income which would not be allowable outside the consolidated tax return) which the regulation is trying to rectify.
- It is bad policy to try to eliminate legal transactions solely to raise taxes. Changing the rules just to raise more revenue often creates unforeseen consequences.