Now you own it, now you don’t: IRS clarifies taxation of rent-a-captives

Phillip England, Anderson Kill & Olick and Randall Beckie, Anderson Kill Insurance Services discuss the pros and cons of rent-a-captives

WHEN YOU rent a captive, is it taxed as if you own it? The IRS recently resolved that question in Revenue Ruling 2008-8. The ruling holds that if a rent-a-captive cell satisfies the tax definitional requirements of an insurance company, it will be treated as a standalone insurance company despite the cell’s lack separate legal status.

In a typical rent-a-captive structure, a sponsor forms a segregated account company (SAC) that consists of segregated cells plus US$1m of capital. The SAC effectively leases each cell to a user who conducts insurance business within the cell. The sponsor provides captive management services to the cell for a fee. Under applicable law, the cell has the licence to write related-party insurance risk or to reinsure unrelated risk. The SAC typically owns the cell’s common voting stock, while the cell’s tenant owns preferred stock. Preferred stock dividends track the cell’s net income. Each cell’s assets and liabilities are insulated from other cells and the sponsor.

The tax treatment of a cell has been ambiguous because cells had merely partial characteristics of corporate personhood. Cells execute contracts for their own account; cells have limited liability; a cell has independent governance if the tenant tells the sponsor how to vote. However, cells are not separate legal entities; they cannot exist independently of their sponsor. Cautious tax advisers steered clients away from rent-a-captives, fearing that the IRS could contradict whatever interpretation the client chose.

Hot potato: game over

Some cell users tried to engineer tax deferral by issuing policies from an offshore cell that failed the tax definitional requirements of risk shifting and risk distribution. The user would deduct a premium paid to the cell, let the cell accumulate underwriting income, and eventually the cell would pay a preferred stock dividend. Under subpart F, offshore captive insurance income may be deemed taxable currently to the shareholder, but the user would claim that subpart F did not apply because voting stock belonged to the sponsor. Meanwhile, the sponsor would say the cell’s income should be imputed to the user. Taken together, the subpart F interpretations of the tenant and sponsor resembled a game of hot potato, and both sides got it wrong.

Rev. Rul. 2008-8 ends this confusion by making the pivotal issue whether the cell’s activity is self-insurance or real insurance. If self-insurance, then the user cannot deduct premiums paid to the cell nor defer recognition of income via preferred stock dividends. If real insurance, then the user is constructively the owner of a standalone captive insurance company.

Some captive advisers have celebrated Rev. Rul. 2008-8 as a bold new interpretation from the IRS, but the interpretation is neither new nor bold. The better argument had long reached the same conclusion that Rev. Rul. 2008-8 now formalises. But the ruling effectively precludes the IRS from treating a rent-a-captive capriciously, and this is progress. The ruling also effectively overturns the commonly held view that captive insurance tax elections (such as the section 953(d) “domestic” election) must be made by the SAC sponsor. Per IRS Notice 2008-19, apparently such tax elections should be made at the cell level, provided that the cell meets the tax definitional requirements of “insurance”.

> ‘A rent-a-captive cell can be less expensive to administer than a traditional captive if the rental fees are low’

Advantages of cell captives for closely-held businesses

The SAC, not the cells, incurs incorporation costs and audit fees (unless auditing at the cell level is desired). A rent-a-captive cell can be less expensive to administer than a traditional captive if the rental fees are low. Currently available rent-a-captives charge rent that rivals audit fees. However, a closely-held business could form a SAC and operate cells within it rent-free. Why do this?

In a closely-held situation, the tax benefit of a captive may lie in one of several corporate income exclusions:

- §501(c)(15): A non-life insurer’s income is exempt if gross receipts do not exceed US$600,000 and premiums constitute 50%+ of receipts. Maximum savings = US$210,000.
- §831(b) election: A non-life insurer’s underwriting income (but not investment income) is exempt if premiums do not exceed US$1.2m. Savings = US$420,000.
- §806: A life insurer’s first US$3m of income is 60% nontaxable. Savings = US$630,000.

These exemptions would be more enticing if family members could own multiple exempt captives (which is possible via careful planning around the controlled group aggregation rules). Multiple captives

would mean multiple overhead costs – unless the captives are cells within a family-owned SAC.

Cells may enhance group captive structures

Group captives usually write too much premium to qualify under §831(b). However, each member of a group could have its own private §831(b) captive that partially reinsures the group captive. A reciprocal reinsurance arrangement among a group of §831(b) captives is potentially much more tax-efficient than a simple group captive. The downside of such an arrangement is the overhead cost of operating multiple captives. A cell-based structure and Rev. Rul. 2008-8 overcome this problem.

Hospitals commonly use offshore cell captives because insurance income from a hospital's own risk (including its doctors' risk) is not unrelated business income (UBI), whereas risk pooling among several hospitals would generate insurance income that is taxable UBI. Hospitals with cell captives historically need not care whether the cell is treated as a separate insurance company or not; the offshore cell structure succeeded in avoiding UBI. However, where offshore not-for-

profit captives exist, often the captives' claims handling operations are onshore. The onshore operations constitute a US branch of the captive that may be subject to branch profits tax on income allocable to the branch. Rev. Rul. 2008-8 would seem to imply that the branch profits tax exposure attaches to the cell captive, not the SAC.

Cell captive taxation still too murky for the mainstream

Proposed captive tax regulations that the IRS issued on September 27, 2007 have been withdrawn, as the IRS told the captive insurance industry on February 20, 2008. The proposed regulations would have wiped out a captive's loss reserve deduction by imposing an elimination entry where a captive was in a tax consolidated group. The captive insurance industry had been up in arms about the proposed regulations.

Considering the importance of including a captive's insurance accounting methods in a corporate taxpayer's consolidated return, rent-a-captive cells remain exceptional in corporate America because it is unclear whether a cell can be consolidated. A parent (and/or affiliates) must own 80% of a captive's stock by vote and value in order to consolidate it. Although a cell's preferred stockholder may be able to tell the sponsor how to vote, the sponsor retains voting control formally. Lingering ambiguities such as this reveal that Rev. Rul. 2008-8 is just a first step in guidance. In Notice 2008-19, the IRS invites comment by May 4, 2008 about how to implement a more comprehensive tax regime for rent-a-captives.

CAPTIVE
INSURANCE COMPANIES

25 YEARS OF CREATIVE CAPTIVE COUNSELING

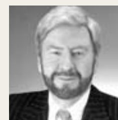
Strategies for Captive Formation and Operation

Corporate Governance and Targeted Investment

Risk Transfer and Risk Distribution Pooling

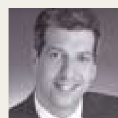
Domestic and Offshore Venues

ANDERSON KILL & OLICK, P.C.
1251 Avenue of the Americas
New York, New York, 10020
212-278-1000
andersonkill.com


Phillip England
(Taxation/Captives)
pengland@andersonkill.com

Isaac Druker
(Corporate/Captives)
idruker@andersonkill.com

Robert M. Horkovich
(Insurance)
rhorkovich@andersonkill.com


William G. Passannante
(Insurance)
wpassannante@andersonkill.com