



# 180°

A guide to what's hot in the world of captives and ART



Strategic Risk Solutions

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## Captive Tax Update

Unfortunately many captive owners and those interested in setting up a captive are often frustrated by the lack of clarity regarding how taxation works relative to a captive. There are no clear references in the Internal Revenue Code ("Code") that can be used as a "how to" manual. In this article, we discuss certain captive tax related questions with Bruce Wright a nationally recognized expert on captive, tax and regulatory issues and a partner with LeBoeuf, Lamb, Greene & MacRae LLP.

### What is a Revenue Ruling and why do they matter?

A Revenue Ruling is a statement of the Internal Revenue Service's ("IRS") position with respect to a specific fact pattern -- interpreting the Code, Treasury Regulations thereunder and/or cases and should be distinguished from a private letter ruling. Although a revenue ruling does not have the same force of law as a case, Revenue Rulings are important, because they can be relied on by a taxpayer with a similar fact pattern. A private revenue ruling, on the other hand, is a response for a request for advice from the IRS with respect to a specific taxpayer and fact pattern and, while informative, cannot be relied on by other taxpayers.

### What is the effect of inconsistencies between case law and Revenue Rulings?

Generally, cases are followed within the federal circuits within which they are decided. For example, if the Tax Court makes a decision regarding a taxpayer in California, that decision would be appealable to the 9<sup>th</sup> Circuit Court of Appeals. If appealed, the 9<sup>th</sup> Circuit Court of Appeals decision would be binding to taxpayers in that Circuit. Additionally, the Tax Court follows its own cases, but may or may not follow U.S. District Court cases and cases from the U.S. Court of Federal Claims and the same is true for these courts. Sometimes the IRS may lose a case in a particular circuit and may issue a ruling (i) stating that the IRS will not follow the case in other circuits and (ii) setting forth the IRS's position for the other circuits.

### Is there anything really new in the latest Revenue Rulings affecting captives?

At the end of 2002, the IRS published a series of Revenue Rulings generally creating safe harbor scenarios in the captive insurance company context. The rulings were not intended to be statements of law per se, however, it is believed that if a taxpayer is in the parameters of one of the rulings, the IRS is expected to rule favorably in a private ruling or audit context. The IRS has raised issues with regard to:

- The necessity of "unrelated" business being homogeneous with "related" business.

- The necessity for a non-tax business purpose for the captive.
- The number of, and relative premium paid by, "brother-sister" entities necessary to secure a deduction for premium paid to a captive, and the nature of such entities, (*i.e.*, single member LLC's which elect to be pass-through entities will not be considered to be separate entities).
- The ability to make loanbacks from the captive to an affiliate. In this regard, various facts may affect this, for example, will there be sufficient liquidity to deal with losses that need to be paid in the ordinary course of business without resort to the loaned assets.
- The number of insureds required for a group captive in order for members to be able to take a deduction for premium.

There is no specific case authority for most of these positions. In addition, the IRS has taken the position that a captive with a single insured will not be respected as an insurance company. It seems to depend on the size of the claim, but often companies don't want to litigate these IRS positions and agree to settle.

### How much third-party business does a company need to reach safe harbor status?

The safe harbor ruling requires 50% unrelated business and also seems to conclude that the unrelated business must be homogeneous. However, case law does not specifically address the homogeneity point and in the *Harper* case, which was decided in the 9<sup>th</sup> Circuit, slightly less than 30% unrelated business was required. In the *Ocean Drilling* case, the Claims Court considered two years in which 44% and 66% unrelated business was deemed sufficient. The likelihood is that if unrelated business is greater than 30 percent the IRS may not decide to litigate. However, they may address the issue in an audit if unrelated business is in the 30-50% range.

## What areas look like third-party business, but might not be in the eyes of the IRS?

Embedded warranties seem to be one issue which would be considered to be the risk of the manufacturer and not that of the customer. The IRS has indicated embedded warranties cannot be insured. If a warranty was sold separately, such as an extended warranty, however, it could be considered unrelated business.

## How Is the IRS viewing rent-a-captives?

Comments were requested on the treatment of rent-a-captives in July 2005 and were filed with the IRS in October 2005. To date, the Service has not published any position on rent-a-captives.

The issues that have concerned people are whether the individual cells in such a company should be treated effectively as independent corporations or whether the whole rent-a-captive should be treated as the insurer. This affects issues for foreign rent-a-captives such as CFC status, ETB status, PFIC status and 953(d) electives to be treated as domestic companies. In addition, in such rent-a-captives there may be issues that arise with regard to risk transfer.

## How does the IRS decide who to audit and what type of captive arrangements have the most risk of being successfully audited?

Some large insureds are audited effectively every year (e.g., in general, Fortune 200 companies are probably audited every year as a matter of course). Of course, the IRS is most interested in pursuing situations with "bad fact patterns" — that have a good likelihood of IRS success.

In Bruce's experience, he has not seen any particular arrangements that were "pulled" for audit and that the issue generally arises because of the particular interest of an agent when he is involved in auditing all of the operations of a taxpayer.

## Is self-procurement tax something captive owners should pay more attention to?

Yes, captive owners should pay attention to self-procurement/direct placement taxes on a number of fronts: first, as a regulatory matter, and second, with respect to tax due. While this is determined on a state by state basis, most states have a self-procurement tax.

Generally insureds in a particular state are required to purchase insurance from a company licensed in that state, however direct placement/self-procurement statutes and industrial insured statutes are exceptions. Direct placement laws generally mandate that the insured leave the state to deal with a company not licensed in the state. Industrial insured statutes give such an unlicensed company the ability to come into a state to deal with an industrial insured (defined generally as a company with 25 employees, which pays a minimum of \$25,000 a year in insurance premium, and has a full time risk manager or consultant).

Most states have statutes -- either in their insurance laws or tax laws which require an insured that enters into one of these transactions to fill out a form and pay tax -- usually 3 to 5 percent.

- New York recently amended its franchise tax return to require a response to a question concerning placement of insurance with a non-admitted carrier;
- Federal legislation has been proposed which would facilitate the payment of such taxes if an insured covered by a policy placed with a non-admitted carrier is located in a number of states

The views expressed in this newsletter are the views of Bruce Wright and should not be considered legal advice. If you have specific company-related questions that you would like to speak to Bruce about, please contact him directly at 1 212 424 8620 or by email at [pwright@llgm.com](mailto:pwright@llgm.com).

## Domicile News

### SRS expands operations into Nevada and Hawaii

SRS has expanded domestic operations as a captive manager in both Hawaii and Nevada.

Hawaii is a mature domestic captive and the second largest domestic captive behind Vermont. It has historically attracted a high proportion of captives with parents on the west coast.

Nevada is a relatively new domicile having only passed its captive law in 2004. It is the fastest growing domestic domicile and 90 licensed captives in its first three years as a domicile.

Our expansion into these domiciles is in response to demand from our clients. We will continue to look at other domiciles as client needs dictate. It allows us to offer a broader range of domicile options to existing and prospective captive domiciles both domestically and offshore.

SRS now has captive management operations in nine domiciles: Arizona, Bermuda, Cayman, Hawaii, Kentucky, Nevada, South Carolina, Vermont and Washington DC.

### South Carolina Emerging Issues Forum

Brady Young and Kathryn Marsh from SRS were invited participants in the emerging issues forum in South Carolina, held in Charleston in May. Our conclusion from the forum is that South Carolina has successfully overcome some recent difficulties in turnover of personnel and is fully committed to expanding the captive industry within the State. South Carolina is set to pass Hawaii into the number two position among domestic captive domiciles this year. With the renewed focus on the captive industry following the forum, we believe South Carolina will go from strength to strength.

More than 60 captive industry leaders and key regulators were involved in the event, which produced nearly 40 recommendations to help re-position South Carolina as the leading domestic captive domicile.

"We intend for South Carolina to become the preeminent captive domicile in the United States and are refocusing our resources to guarantee unparalleled service and professional expertise in the captive industry," commented Director Richardson at the conclusion of the event.

Since the domicile is maturing and experiencing impressive growth, industry leaders and regulators acknowledged that it was time to re-evaluate our vision for the domicile, determine what activities we need to undertake to reach that vision and refocus our collective efforts to ensure future success.

The recommendations generated from this meeting have been organized and are now being processed by the Department and SCCIA to determine implementation plans. An update on the status of these recommendations will be made at the association's Mid-Year Executive Forum, which is scheduled for June 19-20, 2007 in Greenville in South Carolina."

## SRS News

### Wells Fargo Selects SRS as Captive Management Partner

SRS has entered into a partnership with Wells Fargo Insurance Services (WFIS) for the provision of captive consulting and management services to Wells Fargo and its clients. Under the arrangement, SRS will manage the operations of the newly created Wells Fargo Insurance Services Captive Management in US onshore and offshore domiciles and provide captive consulting services to WFIS. ***SRS' existing captive management operations will be unaffected by this development and will continue to operate under the SRS name.***

SRS was chosen as the captive management partner after a selection process among leading independent captive management firms. SRS will initially manage WFIS Captive

Management operations in Vermont, South Carolina, Arizona, Hawaii, Nevada, Bermuda and the Cayman Islands. Other domiciles will be considered depending on the needs and preferences of WFIS clients.

**Client News** – SRS is pleased to welcome the following new captive clients:

- **Oasis Mutual Assurance SPC** has appointed SRS as Insurance Manager. Oasis is a Cayman Islands captive owned by a physician service organization. It provides segregated portfolios to physicians groups.
- **Allied North America Insurance Company**, a newly formed pure captive in Vermont, has appointed SRS as its manager. The captive is a subsidiary of Allied North America and will underwrite professional liability insurance.

**Our People** – SRS is pleased to welcome the following new hires:

**Judy Wong** has joined SRS as a financial analyst in the Waltham office. Judy will provide analytic support on consulting projects for SRS. She has a BSBA in Finance from Suffolk University.

**Cara Tripoldi** has joined SRS as an Assistant Account Manager in the Burlington Vermont office. Cara is a recent graduate of Champlain College, Burlington, Vermont with a BS in Accounting

**Events** – SRS will be participating in the following upcoming industry events:

- **VCIA annual conference, August 7-9:** SRS will be exhibiting at the conference with many of our senior staff attending the conference. Please contact us at [info@strategicrisks.com](mailto:info@strategicrisks.com) to arrange meetings with our team at the conference.

**SRS Webinar Series** - SRS hosts periodic webinars on topical issues affecting the captive insurance industry. To ensure you are included on the distribution list for webinar announcements, contact us at [info@strategicrisks.com](mailto:info@strategicrisks.com).

Strategic Risk Solutions (SRS) is an independently owned captive management and consulting firm. The company is an approved manager of captive insurance companies in most leading onshore and offshore domiciles. SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate.

For more information on SRS, visit us at [www.strategicrisks.com](http://www.strategicrisks.com).

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