

Financial Services

Captive Insurance Update

Bermuda

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Proposed Intercompany Insurance Regulations September 2007

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Proposed Intercompany Insurance Regulations

Today the IRS issued proposed regulations that provide guidance regarding the treatment of transactions involving obligations between members of a consolidated group and the treatment of transactions involving the provision of insurance between members of a consolidated group. The regulations will affect corporations filing consolidated returns and have specific impact on certain captive insurance arrangements.

Under current regulations (§1.1502-13(e)(2)(ii)(A)), if a member provides insurance to another member in an intercompany transaction, the transaction is taken into account on a separate entity basis. As such, premiums, reserve increases and decreases, and other similar items are determined and taken into account under the members' separate entity method of accounting rather than under the matching rule of §1.1502-13(c) and the acceleration rule of §1.1502-13(d). The proposed regulations indicate that the IRS and Treasury believe that separate entity treatment for direct insurance transactions is inappropriate where a significant amount of the insuring member's business arises from transactions with other group members and that the separate entity treatment of insurance payments from one member of a group to a captive insurance member may now have a greater effect on consolidated taxable income than was anticipated when the current regulations were issued.

The proposed regulations provide that, where a significant portion (5 percent or more) of the business of an insuring member (in such case, a "significant insurance member") arises from insuring the risks of other members, it is appropriate to take into account the items from the intercompany transactions on a single entity basis. In such cases, the treatment of the members' items from the insurance transactions are subject to the matching and acceleration rules of §1.1502-13 and will no longer be controlled by §1.1502-13(e)(2)(ii)(A) and (B).

Under these rules, the insured member's deduction and the significant insurance member's income from the transaction will generally be taken into account currently. However, the effects of the intercompany transaction will otherwise be treated in a manner comparable to "self-insurance" by a single corporation. For example, the significant insurance member's discounted unpaid losses under section 832(b)(5) will be determined without regard to the intercompany insurance transaction, and such member will instead take deductions with respect to losses incurred on intercompany insurance under the principles of sections 162 and 461 (e.g., cash method of accounting). On the other hand, if a 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, then under single entity principles, these proposed regulations generally permit the significant insurance member to increase its reserve item under section 807(c) or 832(b)(5) with respect to the premium payment. These proposed regulations continue to except intercompany insurance transactions from single entity treatment where intercompany insurance represents less than 5 percent of the insuring member's business.

PwC Observes: While the preamble states that the insured member's deduction and the significant insurance member's income from the transaction will generally be taken into account currently, proposed

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regulation §1.1502-13(e)(2)(ii)(C) clarifies that the timing and attributes of the premium payments will be taken into account under the matching and acceleration rules and will not be accounted for under section 832(b)(4).

Reinsurance transactions engaged in by group members that attempt to circumvent the single entity rules of §1.1502-13(e) may be subject to the anti-avoidance rules of §1.1502-13(h). For example, if a member enters into an insurance contract with a third-party and the contract is then reinsured with a member of the group, appropriate adjustments will be made to carry out the purposes of the intercompany transaction regulations.

In making the determination of whether an insuring member is a “significant insurance member” and, therefore, is subject to the special rules described above, these proposed regulations use an amount determined under section 832(b)(4)(A) (gross premiums written during the taxable year less return premiums and premiums paid for reinsurance) to measure the insuring member’s annual insurance business.

PwC Observes: These regulations have the effect of eliminating the tax benefits associated with certain related party insurance transactions which have been provided for by the courts in a number of captive insurance cases in arguing against the Service’s “economic family” theory. A wholly owned captive where the insurance is “related party” and not unrelated (i.e. warranty coverage for example), will no longer be entitled to a reserve deduction, but will, in fact, it appears, be required to wait until such losses are paid by the insured. The effect of the proposed regulation is to put self insured taxpayers and taxpayers with valid captive insurance arrangements on the same footing if they are members of a consolidated group.

The IRS requests comments as to whether premiums is an appropriate measure of an insuring member’s business, as well as suggestions for alternatives. The IRS is also considering whether the status of an insuring member as a “significant insurance member” should be an annual determination and whether additional rules are needed when an insuring member’s status changes. The IRS requests comments in this regard, in addition to whether any additional special rules are needed to accomplish single entity treatment for intercompany insurance transactions.

PwC Observes: These proposed regulations under §1.1502-13(e) apply to intercompany transactions involving the provision of insurance occurring in consolidated return years beginning on or after the date these regulations are published as final regulations in the Federal Register.

For additional information please call Richard E. Irvine at (441) 299-7136 or contact your local insurance tax professional.

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