

# Financial Services

## Captive Insurance Update

Bermuda

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### IRS Issues Guidance with Respect to “Cell” Companies January 16, 2008

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Alert Number: 08-01

#### Revenue Ruling 2008-08

The Internal Revenue Service issued Revenue Ruling 2008-08 which provides the first significant guidance with respect to transactions between “cells” of a Protected Cell Company and potential insureds.

In the Ruling the Service analyzed two transactions involving related party insureds (e.g., “participants”) and “cells” of a Protected Cell Company.<sup>1</sup> Key facts stated in the Ruling include:

- A Protected Cell Company is a legal entity which has established multiple accounts or “cells”.
- The cells of are not treated as a legal entity distinct from the Protected Cell Company under the laws of Jurisdiction A.
- The Sponsor owns all of the Common Stock of the Protected Cell Company.
- All of the non voting preferred stock associated with each cell is owned by the cell’s participant or participants.
- Each cell is funded by its participant’s capital contribution and by premiums collected from the insureds and is adequately capitalized relative to the risks assumed.
- The participant has not provided any guarantee of the cell’s performance.
- Each cell has the ability to pay out claims with respect to contracts to which the cell is a party.
- The income, expense, assets, liabilities and capital of each cell are accounted for separately.
- The assets of each cell are statutorily protected from the creditors of any other cell and from the creditors of Protected Cell Company.
- The participant is entitled to a return of the assets of the cell in which it participated (subject to any outstanding obligations of that cell).
- The cell enters into a 1-year contract whereby the cell “insures” professional liability risks of the participant.
- In all respects the cell and the participants conduct themselves consistently with the standards applicable to an insurance arrangement between unrelated parties.
- Cell does not loan funds to the participants.
- Cell conducts no other business other than with the participant.

Under the first transaction, Cell X is owned by X, a domestic corporation. X is the only insured. The Service applies the definitional tests for insurance as set forth in Helvering v. LeGierse (e.g.,

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<sup>1</sup> The Service collectively referred to a Protected Cell Company to include a protected cell company, a segregated account company or segregated portfolio company.

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risk shifting and risk distribution) and historical case law and rulings dealing with a “parent/subsidiary” insurance relationship (Ocean Drilling & Exploration Co., 24 Cl. Ct. 714, 731 (1991) aff’d per curiam, 988 F.2d 1135 (Fed. Cir. 1993); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992); Rev. Rul. 2002-89, 2002-2 C.B. 984. The Service asserts that “the same principles apply to determine the insurance contract status of an arrangement involving a cell of a protected cell company as apply to determine the status of an arrangement with any other issuer”.

The Service concludes that the arrangement between X and Cell X is akin to an arrangement between a parent and its wholly-owned subsidiary, which, in the absence of unrelated risk, lacks the requisite risk shifting and risk distribution to constitute insurance and X may not deduct amounts paid pursuant to the arrangement as “insurance premiums” under §162 (a).

Under the second transaction, Cell Y is owned by Y, a domestic corporation. Y owns all of the stock of 12 domestic subsidiaries. Each of the subsidiaries operates in a separate state where the subsidiary provides professional services. The subsidiaries operate on a decentralized basis; however, the general categories of the professional services rendered by each of the subsidiaries are the same throughout the Y group. Together, the 12 subsidiaries have a significant volume of independent, homogeneous risks and no subsidiary represents liabilities for less than 5% nor more than 15% of the total risk insured by Cell Y. Cell Y retains the risk that it insures from the subsidiaries. Once again, the Service applies the definitional tests for insurance as set forth in Helvering v. LeGierse (e.g., risk shifting and risk distribution) and historical case law and rulings dealing with a “brother/sister” insurance relationship (Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989); Kidde Industries v. U.S., 40 Fed. Cl. (1997); Rev. Rul. 2002 90, 2002 2 C.B. 985).

The Service concludes that the arrangements between Cell Y and each subsidiary of Y are insurance contracts for federal income tax purposes; amounts paid pursuant to those arrangements are insurance premiums, deductible under § 162(a).

**PwC Observes:** The Ruling provides a practical approach to the tax treatment of transactions between cells and their participants which relies in a large part on existing case law and revenue rulings.

## IRS Notice 2008-19

In conjunction with Revenue Ruling 2008-08, the Service also issued Notice 2008-19 addressing the insurance company characterization and the availability of certain federal tax elections associated with cell captive insurance arrangements. The Notice requests comments on further guidance to address issues that arise in cell company arrangements which do constitute insurance, specifically (a) the status of such a cell as an insurance company within the meaning of §§ 816(a) and 831(c), and (b) some of the consequences of a cell’s status as an insurance company.

The Notice provides “proposed guidance” which would treat a cell as an insurance company separate from any other entity if:

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- The assets and liabilities of the cell are segregated from the assets and liabilities of any other cell and from the assets and liabilities of the Protected Cell Company; such that no creditor of any other cell or of the Protected Cell Company may look to the assets of the cell for the satisfaction of any liabilities, including insurance claims (except to the extent that any other cell or the Protected Cell Company has a direct creditor claim against such cell); and
- based on all the facts and circumstances, the arrangements and other activities of the cell, if conducted by a corporation, would result in it being classified as an insurance company within the meaning of §§ 816(a) or 831(c).

The effect of the insurance company treatment at the cell level would be as follows:

- Any tax elections that are available by reason of a cell's status as an insurance company would be made by the cell (or, in certain circumstances, by the parent of a consolidated group) and not by the Protected Cell Company, of which the cell is a part (e.g., §953(d) or §831(b)).
- The cell would be required to apply for and receive an employer identification number (EIN) if it is subject to U.S. tax jurisdiction.
- The activities of the cell would be disregarded for purposes of determining the status of the Protected Cell Company as an insurance company for federal income tax purposes.
- The cell (or, in certain circumstances, the parent of a consolidated group) would be required to file all applicable federal income tax returns and pay all required taxes with respect to its income.
- A Protected Cell Company would not take into account any items of income, deduction, reserve or credit with respect to any cell that is treated as an insurance company under this proposed rule.

The proposed guidance would be effective for the first taxable year beginning more than 12 months after the date the guidance is published in final form.

The Service has requested comments given that the statutes under which Protected Cell Companies are chartered differ among various jurisdictions, and cell arrangements differ among taxpayers due to variations in contractual terms. In order to ensure that entity classification and federal tax elections for Protected Cell Companies are both legally correct and administrable in all cases, the Service requests comments on the proposed guidance described in this Notice. In particular, the Service has requested comments on:

- What transition rules may be appropriate or necessary for Protected Cell Companies, or cells of such companies.
- If a Protected Cell Company is not currently following the proposed rule, or if a cell of such a company qualifies as an insurance company for some taxable years but not for others.
- What reporting, if any, would be necessary on the part of an individual cell to ensure that a Protected Cell Company has the information needed to comply with the reporting of income and expense of the cell and the Protected Cell Company.
- Whether different or special rules should apply with respect to foreign entities, including controlled foreign corporations.

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- Whether further guidance would be needed concerning the proper treatment of Protected Cell Companies and their cells under the proposed rules regarding consolidated returns.
- What guidance, if any, would be appropriate concerning similar segregated arrangements that do not involve insurance.

**PwC Observes:** The separate entity treatment set forth in the proposed rules may bring into play unintended tax consequences to the owners of cells. In particular, the application of the controlled foreign corporation rules and the proposed regulations under §1.1502-13(e) as they are intended to apply to intercompany transactions in consolidated group.

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

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