Financial Services
Captive Insurance Update
Bermuda
PRICEWATERHOUSECOOPERS

FIN 48 and Captive Insurance Companies

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On January 17, 2007, the Financial Accounting Standards Board (FASB or the Board) unanimously affirmed its previous decision to make FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), effective for fiscal years beginning after December 15, 2006. Accordingly, companies with calendar year-ends will need to adopt the provisions of FIN 48 as of January 1, 2007. Under the Interpretation, a company's financial statements will reflect expected future tax consequences of uncertain tax positions ("UTP").

The interpretation of FIN 48 consists of two main points: 1) A tax benefit/expense may be reflected in the financial statements only if it is "more likely than not" that the company will be able to sustain the UTP, based on its technical merits; and 2) A tax benefit/expense should be measured as the largest amount of benefit/expense that is cumulatively greater than 50-percent likely to be realized.

While promoting increased standardization of current practice, FIN 48 could have significant consequences for a large number of companies including (but not limited to):

- Less flexibility for management in determining reserves for tax exposures as compared to existing practices.
- Taxpayers may need to increase transparency of tax exposures, which may trigger inquiries by analysts and could affect the behavior of taxing authorities.
- Lead to larger cash outlays for taxes, due to a diminished appetite for taking aggressive tax positions.
- Greater income statement volatility and increased risk of non-recurring financial statement effects from income taxes as management's assessments of uncertain tax positions change over time.

<u>Captive Insurance – an Uncertain Tax Position</u> – Given the judicial history of captive insurance, one would expect that the tax treatment of transactions with a related party insurance company would fall into the category of an UTP. Common tax issues with regards to captive insurance companies are as follows:

- Whether the transactions with the captive qualify as "insurance" for U.S. federal income tax purposes.
- Whether the captive meets the definition of an "insurance company" for U.S. federal income tax purposes.
- Whether the captive has a valid IRC §953(d) or IRC §953(c)(3)(C) election.
- Whether the loss reserves booked by the captive are "fair and reasonable".

- Whether there is an impact of the loanback of significant assets to related affiliates on the tax status of the captive.

The timing of FIN 48 as it applies to captive insurance companies will vary. FIN 48 is effective for fiscal years beginning after December 15, 2006. To effectively apply FIN 48, companies will need to identify all significant income tax exposures existing as of the adoption date, including all uncertain positions in all tax years still subject to assessment or challenge under relevant tax statutes. Identification and assessment should occur with regards to captives issuing US GAAP financials for the period after the effective date.

Captives owned by SEC registrants may be required under Staff Accounting Bulletin No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* (SAB 74) to evaluate the new accounting standard to determine the appropriate disclosure for financial statements ending prior to the enactment date (e.g., for 10K disclosure for fiscal years ending after December 15, 2006) and the captive UTP may impact that analysis.

Alternatively, captives not assessing the implications of FIN 48 for SAB 74 purposes, will need to do so for stand alone US GAAP financial statements for fiscal years beginning after December 15, 2006.

For additional information please call Rick Irvine at (441) 299-7136 or your PricewaterhouseCoopers tax advisor.