BUSINESS INSURANCE

WORLD CAPTIVE FORUM

General Track: Hot Topics

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Agenda

- Developments affecting Domicile Selection
  - Proposed PFIC Regs
  - Washington State and Direct Placement Taxes
- Withdrawing From Pools
- Structures Failing Risk Transfer for Accounting Purposes
- Why Large Captive Owners Should Pay Attention to Small Captive Developments

Developments Affecting Domicile Selection

Proposed PFIC Regs

- WHO THE NEW PROPOSED PFIC RULES WILL AFFECT AND WHO THEY WILL NOT AFFECT
  - SINGLE MEMBER OWNER CONTROLLED FOREIGN CORPORATION (“CFC”)
  - SINGLE MEMBER OWNER IRC § 953(d) ELECTION
  - MULTI-OWNER TRADITIONAL CFC ALL 10% U.S. SHAREHOLDERS
  - MULTI-OWNER TRADITIONAL CFC SOME SHAREHOLDERS NOT 10% U.S. SHAREHOLDER
  - MULTI-OWNER RELATED PERSON INSURANCE INCOME (“RPII”) CFC
  - MULTI-OWNER RPII CFC SUBJECT TO EXCEPTION
  - MULTI-OWNER ENTITY SUBJECT TO 953(c)(3)(c) ELECTION

WASHINGTON STATE AND DIRECT PLACEMENT TAXES

- INITIALLY (MICROSOFT) APPARENT ALLEGATIONS WITH RESPECT TO IMPOSING 2% TAX ON PREMIUM RELATED TO WASHINGTON STATE RISK WITH RESPECT TO WASHINGTON-BASED ENTITIES
- EXPANDED TO APPLY TO CAPTIVES AND OTHERS WITH RESPECT

  TO RISK IN WASHINGTON STATE
- PROVISIONS OF NON-ADMITTED REINSURANCE AND REFORM ACT ("NRRA")
  - HOME STATE
  - PREMIUM
  - PREEMPTION

WASHINGTON STATE AND DIRECT PLACEMENT TAXES

- MICROSOFT
- COSTCO
- ALASKA AIRLINES
- CCW SAFE, LLC AND 2A INSURANCE COMPANY
- STARBUCKS

Withdrawing From Pools

Withdrawing from Pools

- TAX CONSEQUENCES OF WITHDRAWING FROM POOLING ARRANGEMENT
  - LOSS OF INSURANCE COMPANY STATUS?
  - LOSS OF IRC § 953(d) STATUS – Domestic to Foreign Transaction
  - IRC § 831(b) STATUS
- CONTRACTUAL CONSEQUENCES OF WITHDRAWAL FROM POOLING ARRANGEMENTS
  - RUN-OFF OBLIGATIONS
    - MAINTENANCE OF CAPITAL
    - COLLATERAL REQUIREMENTS
  - MAINTAIN INSURANCE LICENSE WHILE IN RUN-OFF
    - CONTINUE TO INCUR MANAGEMENT, ACTUARIAL, ETC. FEES
  - MUST GET DOI APPROVAL TO LEAVE STATE, SURRENDER LICENSE, ETC.

Structures Failing Risk Transfer for Accounting Purposes

Risk Transfer – Central issues and Background

- Why do we care about Risk Transfer?
  - Deposit accounting, used when a contract fails risk transfer, does not provide surplus relief
  - Tax deductibility of premium payments at risk
- NAIC has also increased scrutiny of risk transfer requirements over last few years

Basic Guidelines

ASC 944-20-15 risk transfer test for reinsurance of short duration contracts

- GAAP – ASC 944-20-15
  - Originally FAS 113 – Risk Transfer is met when:
    - The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance agreements; and
    - It is reasonably possible that the reinsurer may realize a significant loss from the transaction.
  - Reasonably possible = more than remote.
  - Leads to the 10/10 rule
- Statutory
  - SSAP No. 62R, *Property and Casualty Reinsurance*
    - Risk transfer rules for STAT are same as under GAAP
    - Paragraphs 10-17 of SSAP 62R
    - Implementation Q&A – Questions 6-21
    - Reinsurance agreements with multiple cedents require allocation agreements (paragraph 9)

Transfer of Risk Guidelines

Examples of Violations of Transfer of Risk

- Has the reinsurer assumed significant insurance risk?
  - Failed if the probability of significant variation in the amount or timing of payments is remote
  - Failed if the amount and timing of payments is not dependent on and directly varies with the ceding company's settlements
- Is it reasonably possible that the reinsurer may realize a significant loss?
  - Professional judgment is required
  - Failed if the PV of cash outflows (premiums) is greater than the PV of cash inflows (recovered losses)

Risk Transfer Red Flags

- Unusually high premium for value of coverage provided (rate online)
- Existence of contingent or sliding scale commission, profit commissions, retrospectively rated premiums
- Accumulating retentions over multiple years
- Experience account/fund balance
- Commutation and termination provisions allowing reinsurer to lock in payment pattern
- Termination provisions limiting ability to cancel
- Related contracts
- Contracts that don't on their face make business sense
- Undefined terms
- Unacceptable insolvency clauses

Effects of Not Satisfying Risk Transfer

- Financial reporting:
  - ASC 944-20 notes the following:

    "In some cases an insurance contract or reinsurance contract does not transfer insurance risk. In those cases, Subtopic 340-30 provides guidance on applying the deposit method of accounting."
- Tax:
  - Based on the conclusion to FAA 20072502F, defining what constitutes an insurance risk for Federal income tax purposes can be a daunting task. In its conclusion the IRS stated:

    "The Annual Statement and SSAP 62 are not controlling for Federal income tax purposes. While an arrangement that fails the risk transfer requirements of SSAP 62 is almost certain to fail the risk transfer requirements for Federal income tax purposes, satisfying SSAP 62 is no guarantee of success for Federal income tax purposes. The controlling authority for Federal income tax purposes is Rev. Rul. 89-96."

Why Large Captive Owners Should Pay Attention to Small Captive Developments

From the Beginning to Now

- The IRS began challenging large captives in 1977 and litigated numerous cases.
- The IRS has more recently been intensely focused on small captives, and the courts have made some disturbing statements.
- If the IRS establishes bad law, it will impose that on large captives.
- The IRS concerns (among other things in Notice 2016-66):
  - No competitive quotes sought, improper intercompany allocation
  - loans to affiliates
- The IRS has trained Insurance Specialists (Technical Guidance) at Audit and Appeals

Selected concerns of the Courts

- The Courts have found if the pooling entity is not an insurance company for tax purposes, then that risks assumed from the pool are not used in computing risk distribution
- The Courts are skeptical of a pool where the premiums for the risks assumed by the pool are comparable (net of ceding commission) premiums for the risks assumed from the pool
- Circular Flow of Funds
- Syzygy disallowed premium deductions, and taxed those premiums to the captive
- The failure to file claims was significant in disqualifying the arrangement
- The Court was concerned about “cookie cutter” policies

Questions