

INTERNAL REVENUE SERVICE ISSUES
IMPORTANT NEW GUIDANCE FOR
COMPANIES CONSIDERING CAPTIVE
INSURANCE ALTERNATIVES

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Today, just as in the mid 1970s and 1980s, the hard insurance market is causing many companies to consider setting up captive insurance companies or joining group captives. This alert, addressing tax issues, is the first of a two-part series dealing with issues concerning the hard insurance market and its impact on clients and friends of the firm.

In December 2002, the Internal Revenue Service issued three revenue rulings and a revenue procedure that, at least within prescribed parameters, provide some measure of certainty regarding the taxation of captive insurance companies. These rulings are particularly important and timely for companies considering their insurance and tax alternatives.

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In This Advisory

- I. [Definition of Captive Insurance Company](#)
- II. [New IRS Position on Economic Family Theory](#)
- III. [Revenue Procedure 2002-75: Ruling Requests Regarding Tax Treatment of Captive Insurance Company](#)
- IV. [Conclusion](#)

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McKenna Long & Aldridge is a full-service law firm of nearly 400 lawyers and public policy advisors with offices in Atlanta, Denver, Los Angeles, Philadelphia, San Diego, San Francisco, Washington, DC, and Brussels. Formed June 1, 2002, through the merger of Long Aldridge & Norman LLP and McKenna & Cuneo L.L.P., the firm provides business solutions in the areas of corporate law, government contracts, intellectual property and technology, complex litigation, public policy and regulatory affairs, real estate, environmental, energy and finance.

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CAPTIVE INSURANCE COMPANIES: IRS RULINGS and PROCEDURES

Definition of Captive Insurance Company

A captive insurance company is an insurance company that is owned or controlled by insureds. All or a significant portion of the risks insured by the captive insurance company are risks of its shareholders or entities related to its shareholders. Captive insurance companies can be formed offshore or in the U.S.

There are numerous business and tax reasons why a captive insurance company may be desirable. A captive can enable a business to acquire insurance at lower cost because underwriting profits and investment income can be retained and access may be gained to the reinsurance market. If the captive is properly structured, tax advantages can be obtained because the premiums paid to the captive may be deducted while the captive itself may be eligible for favorable tax treatment. Certain small insurers may be exempt from tax or be taxable only on investment income while larger insurers benefit from deductions for reserves for unpaid losses.

[Back to Top](#)

New IRS Position on Economic Family Theory

Case law indicates that insurance involves "risk-shifting" and "risk-distributing." For many years, beginning with the issuance of a revenue ruling in 1977, the Internal Revenue Service argued that where the insurer and insureds are members of the same economic family, the requisite "risk-shifting" and "risk-distributing" are not present and therefore sought to deny the tax benefits (deductibility of premiums and favorable tax treatment of the insurer) that were claimed through the use of captive arrangements. The Internal Revenue Service's position was consistently

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rejected by the courts, particularly where the insured and the insurer are not parent and subsidiary corporations but rather are brother-sister corporations. Finally, in 2001, after a string of losses in the courts, the Internal Revenue Service stated that it would no longer invoke the economic family theory with respect to captive insurance transactions.

The Internal Revenue Service has now gone further in illustrating its new position in three Revenue Rulings. Each Revenue Ruling deals with a different type of captive insurance arrangement.

Parent-Subsidiary Captive Structure

The first ruling, Revenue Ruling 2002-89, deals with a parent-subsubsidiary captive structure. A parent corporation formed a wholly-owned subsidiary insurance company. The ruling considered two situations. In the first situation, the premiums the subsidiary earns from the arrangement with its parent constitute 90% of the subsidiary's total premiums earned during the taxable year on both a gross and net basis. The liability coverage the subsidiary provides to its parent accounts for 90% of the total risks borne by the subsidiary. In the second situation, the premiums the subsidiary earns from the arrangement with its parent constitute less than 50% of the subsidiary's total premiums earned during the taxable year on both a gross and net basis. The liability coverage the subsidiary provides to its parent accounts for less than 50% of the total risks borne by the subsidiary. The IRS concludes that in the second situation, the requisite risk shifting and risk distribution to constitute insurance for federal income tax purposes are present. Therefore, the IRS ruled that in this situation, the premiums paid by the parent were deductible as insurance premiums.

Brother-Sister Captive Structure

The second ruling, Revenue Ruling 2002-90, deals with a brother-sister structure. In that ruling, a parent corporation formed a subsidiary that insured the risks

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of 12 other operating subsidiaries. None of the operating subsidiaries have liability coverage for less than 5%, nor more than 15%, of the total risk insured by the insurance subsidiary. In this instance, the IRS rules that the premiums paid by the operating subsidiaries to the insurance subsidiary are deductible.

Multi-Owner or Group Captive Structure

The third ruling, Revenue Ruling 2002-91, deals with a "multi-owner" or "group" captive. In this ruling, a small group of unrelated businesses involved in a highly concentrated industry formed a group captive. The captive provides insurance only to the members. No member owns more than 15% of the captive, and no member has more than 15% of the vote on any corporate governance issue. In addition, no member's individual risk insured by the captive exceeds 15% of the total risk insured by the captive. The IRS rules that in this situation, the amounts paid as "insurance premiums" pursuant to that arrangement are deductible as ordinary and necessary business expenses and further that the captive is in the business of issuing insurance and will be treated as an insurance company for tax purposes.

[Back to Top](#)

Revenue Procedure 2002-75: Ruling Requests Regarding Tax Treatment of Captive Insurance Company

In Revenue Procedure 2002-75, the Internal Revenue Service announced that it will now consider ruling requests regarding the proper tax treatment of a captive insurance company. Prior to the issuance of this Revenue Procedure, the IRS would not ordinarily issue rulings regarding the deductibility of premiums paid to captives or the status of captives as "insurance companies."

Conclusion

The new Revenue Rulings, in effect, provide safe harbors for captive structures that fall squarely within their facts. While these rulings are helpful, courts in certain instances have blessed structures that go beyond those described in these rulings. It remains to be seen whether under its new ruling policy, the IRS will issue rulings on structures and facts that differ materially from those described in these rulings.

Captive insurance companies are not for everyone. The cost in setting up and maintaining these structures may in many instances exceed the obtainable benefits. However, captive insurance companies are an important business and tax planning tool for many.

McKenna Long & Aldridge LLP is experienced in helping clients evaluate and implement various captive insurance structures ranging from privately owned captives to association captives/risk retention groups. The firm's captive and general insurance expertise extends to many disciplines, including corporate, tax, insurance company regulation, risk management, general litigation/claims administration and insurance recovery litigation. The firm coordinates with accounting, management and actuarial firms and brokers to implement captive structures and with foreign law firms to implement offshore structures.

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