



Captive Insurance Taxation: Federal and State Update

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SPEAKERS



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Agenda

- Address what you would like to know about
- State Tax Issues
- Federal Tax Issues
 - Proposed “micro-captive” regulations
 - Supreme Court activity that may affect taxation
 - Other IRS activity



State Tax Issues

- Corporate State Income/Franchise Tax vs. State Premium Tax
- State and Local Updates
 - Unitary/combined rules
 - Types of income and nexus
 - Captives with “services” income or Services Co ownership where Service Co is a SMLLC
- Self-Procurement Tax



Corporate State Income/Franchise Tax vs. State Premium Tax

- **Generally, if the Company is registered in the state or has income allocated to the state (Sch. T) there is a filing requirement. See *qualifying to doing business rules on the right.***
- States that impose an income tax on insurance companies:
 - Florida
 - Illinois
 - Louisiana
 - Mississippi
 - Nebraska
 - New Hampshire
 - Oregon
 - **Other**
 - **NY – Life insurance companies**
 - **Wisconsin – non-life domestic insurers/foreign insurers exempt from franchise tax**

Jurisdictions	Jurisdiction to Tax and Limitations on State Taxation Doing Business or Transacting Business Qualifying to Do Business
Florida	Yes. In Florida, a foreign corporation must obtain authority from the Department of State prior to doing business in the state. [Fla.
Illinois	Yes. In Illinois, a foreign corporation must obtain authority from the Secretary of State prior to doing business in the state. [805 ILCS
Louisiana	Yes. In Louisiana, a foreign corporation must obtain authority from the Secretary of State prior to doing business in the state.
Mississippi	Yes. In Mississippi, a foreign corporation must obtain authority from the Secretary of State prior to doing business in the state. [Miss.
Nebraska	Yes. In Nebraska, a foreign corporation must obtain authority from the Secretary of State prior to doing business in the state. [Neb.
New Hampshire	Yes. In New Hampshire, a foreign corporation must obtain authority from the Secretary of State prior to doing business in the state. [
Oregon	Yes. In Oregon, a foreign corporation must obtain authority from the Secretary of State prior to doing business in the state. [Or.



State and Local Update

- General considerations
 - Continued focus by state DORs on inclusion/exclusion of a captive insurance company from Unitary/Combined filings
 - Localities joining in on the legislation where current guidance is silent or ambiguous
 - Related party add-back issues (e.g., Illinois add-back provisions)
 - Expected changes in legislation (most likely adverse to taxpayers) may result in additional state and local tax liability for the overall combined groups
- Warranty and obligor companies
 - Subject to state and local tax or not?
 - Registration and regulation details



Self-Procurement Tax (p.1)

- **What is SPT?**

- Self- or Independent Procurement Tax
- Tax is paid by the named insured on the policy for premiums paid to an insurer not authorized in the state.
 - 45-46 states impose a self-procurement tax.
 - Rates range from 0.5% (IL) to 6% (OK, SC).
 - Other states either don't impose the tax or statutory language would put burden on the unauthorized company.
 - NY – historically has always enforced this tax.
 - Nonadmitted Reinsurance Reform Act (15 USC §8201 et. seq.) sets forth the rules for determining the state (only one) where tax is to be paid.



Self-Procurement Tax (p.2)

- **Who is liable for SPT?**
 - What happens in an affiliated group of companies with more than one insured?
 - SPT in corporate reorganization



Self-Procurement Tax (p.3)

- Washington State
 - The tax/fee/licensing of out-of-state captives applies to any captive that has an owner that has its principal place of business in Washington.
 - Must register and annually pay a fee of \$2,500; and
 - Must pay an annual premium tax on 2% of premiums directly procured by the captive on **Washington risks**.
 - Reinsurance assumed is not taxable; unclear on how ocean marine premium would be treated.
 - Principal place of business not defined (NY uses “nerve center” test from *Hertz Corp. v. Friend* for SPT).



Self-Procurement Tax (p.4)

Direct Procurement Tax Range	States
No Law	DC, GU, IN, MA, SC, VA, WA, WV
0.50% to 2.50%	AR, ID, IL, IA, KY, MI, MN, ND, OR, SD
2.51% to 3.50%	AZ, CA, CO, DE, ME, MD, MS, MT, NE, NV, NM, PA, VT, WI, WY
3.51% to 4.50%	AL, AK, CT, GA, NH, NY, RI, UT
4.51% to 5.50%	FL, HI, LA, MO, NC, NJ, OH, TN, TX, USVI
Over 5.50%	KS, OK, PR



Federal Tax Issues

- Proposed “Micro-Captive” Regulations
 - IRS Proposed Regulations: Micro-Captive Listed Transactions and Transactions of Interest
 - Section 831(b) Proposed Regulations
 - What’s in Them?
 - What’s Next?
 - What the Industry Said
- U.S. Supreme Court Watchlist
 - Delaware Department of Insurance v. United States of America
 - Loper Bright Enterprises, et.al. v. Raimondo
 - Moore v. United States of America



Proposed “Micro-Captive” Regulations



IRS Proposed Regulations: Micro-Captive Listed Transactions and Transactions of Interest

- April 11, 2023: IRS issued proposed regulations on most captive insurance companies making a Section 831(b) election (a/k/a “micro-captives” or “831(b) captives”)
- IR-2023-74 (April 10, 2023):
 - IRS mentions Notice 2016-66, where it previously identified certain micro-captive transactions as transactions of interest but notes that the Sixth Circuit and US Tax Court have held the notice lacked authority because the IRS did not follow notice and comment procedures
 - IRS states it disagrees with these rulings and will continue to litigate such matters outside the Sixth Circuit. However, the IRS will “no longer take the position that transactions of interest can be identified without complying with notice and public comment procedures. Treasury and the IRS issued the proposed regulations to ensure that these decisions do not disrupt the IRS' ongoing efforts to combat abusive tax shelters throughout the nation.”
 - IRS points to 3/3 micro-captive and one section 501(c)(15) victories in Tax Court



Section 831(b) Proposed Regulations – What's In Them? (p.1)

- New regulations will obsolete Notice 2016-66
- Harsher than Notice 2016-66 for some– Some micro-captive arrangements will become listed transactions instead of transactions of interest
- If the captive meets the definitions in the proposed regulations, it must file Form 8886. Material advisors must file Form 8918. Same forms as Notice 2016-66
- Many captives and material advisors have been filing these forms since Notice 2016-66 – even after it was vacated by the District Court.



Section 831(b) Proposed Regulations – What’s In Them? (p.2)

- Overall, many similarities to Notice 2016-66. These regulations tweak the definitions of micro-captives that are required to report. It applies when a captive issues a contract to the insured or reinsures a contract issued to the insured by an intermediary
- Micro-captives are a **listed transaction** if either:
 - Over a 5-year reporting period, there is a financing agreement between the captive and a related party (*e.g.*, loan-backs) of premiums (not net investment income) [or an earlier loan that is still outstanding]; or
 - Over a 10-year reporting period, the captive has a loss ratio of 65%. The loss ratio can be increased by the captive paying policyholder dividends.
- Micro-captives are a **transaction of interest** if:
 - The captive has a loss ratio of 65% if the captive has been in existence less than 10 years and no financing arrangement



Section 831(b) Proposed Regulations – What's In Them? (p.3)

- Loss ratio that triggers reporting is lowered from 70% (Notice 2016-66) to 65%
- Captives that provide consumer coverage, such as extended warranties on automobiles, are not included (unrelated third-party risk) nor is insurance for certain employee compensation or benefits
 - The Consumer Coverage exception was discussed in an earlier session
- IRS urges Section 831(b) captives and their owners to consider amending their returns



Section 831(b) Proposed Regulations – What’s Next?

- June 12, 2023: 110 comments filed with the IRS
- July 19, 2023: Public hearing held via teleconference. 6 speakers – one domicile, three lawyers, one CPA, one captive owner
- When the IRS finalizes the regulations, the IRS will be required to state what it did with each major comment, including why the IRS did not make a change in response to a comment.
- The IRS is not obligated to make any changes so long as it explains why it did not, and was not “arbitrary and capricious”
- IRS has stated they want to finalize the regulations by the end of 2023



Section 831(b) Proposed Regulations – What the Industry Said (p.1)

- The comments came from an array of commentators: government entities, captive managers, associations, captives, insureds, owners, service providers, etc.
 - Many described why captive insurance was important to the insured's business
 - Many described claims (including COVID claims) rejected by the commercial market, that were covered by captive policies (51% of which were borne by others, under some programs)
- Fundamental Question
 - Do the comments apply to captives that don't elect section 831(b) ? OR
 - Are loan-backs and a less than 65% loss ratio, only abusive for micro-captives?
- Oklahoma Insurance Department suggested a Joint Task Force comprised of (1) the IRS; (2) Captive regulators; and (3) representatives of the captive insurance industry



Section 831(b) Proposed Regulations – What the Industry Said (p.2)

- McCarran-Ferguson and state regulation of Captives
 - States have exclusive authority to regulate the “business of insurance”
 - National Council of Insurance Legislators (NCOIL) – loss ratio regulation violates McCarran-Ferguson
- 65% loss ratio – American Academy of Actuaries and others
 - A single, countrywide, all coverages, loss ratio is inappropriate
 - 65% is the wrong percentage
 - Loss ratio is the wrong measure; a better test is the method to compute premiums.
 - Loss ratio can only be determined after the year is over
 - When paying the premium, taxpayers do not know if the transaction is reportable
 - Policyholder dividends have issues and may need regulatory approval



Section 831(b) Proposed Regulations – What the Industry Said (p.3)

- Loan-Backs and Financing Transactions
 - Only applies to premiums, not to the net investment income
 - The IRS asked for comments on loan-backs in 2005, but did not do anything with the comments
 - *Rent-A-Center* found insurance present when captive assets bought parent treasury stock
 - Instead of \$1 of loan back of premium; have the standard consistent with the court cases of *Rent-A-Center*, *Avrahami* and *Syzygy*
- Consumer Coverage Exclusion –
 - Similar to PORCs – 2002 listed transaction and 2004 removal from listed transaction list
 - Question 50% commission requirement and its computation
 - Commercial fronting companies should have few or no reporting requirements



Section 831(b) Proposed Regulations – What the Industry Said (p.4)

- Industry suggested approaches
 - Don't finalize the regs because of McCarran-Ferguson
 - Don't finalize the regs before the Supreme Court rules in *Loper* on deference
 - No captive transaction should be “listed” (automatically tax avoidance) – too fact based
 - Allow captives to revoke section 831(b) for all open years without IRS approval
 - Appeals Office should independently evaluate “micro-captive” appeals
- Compliance, retroactivity, duplicate filings
 - The burden of the regs and the cost of compliance are greater than the IRS realizes
 - Changes should be prospective only
 - Neither participants nor material advisors should have to re-file prior filings
 - A captive with insurance losses, may pay more tax under 831(b), than 831(a)



U.S. Supreme Court Watchlist



U.S. Supreme Court Watchlist (p.1)

- **Delaware Department of Insurance v. United States of America**
 - Enforcement of a summons for “confidential” information
 - IRS declined to affirm that it would never disclose the information
 - District Court and Third Circuit concluded this was NOT the “business of insurance”, thus the IRS summons trumped Delaware law requiring privacy
 - The documents will not be released publicly while the case continues
 - Delaware has asked the US Supreme Court to hear the case; we don’t know whether the Court will do so
 - The IRS is sending inquiries to a number of states



U.S. Supreme Court Watchlist (p.2)

- **Loper Bright Enterprises, et.al. v. Raimondo**
 - Courts often defer to Government agencies (e.g., EPA, OSHA, FTC, IRS, etc.) to interpret the law and write regulations
 - This case will consider whether the current standard should be modified
 - If changed, it may affect whether Courts will uphold the validity of regulations, and affect those Courts' analysis



U.S. Supreme Court Watchlist (p.3)

- **Moore v. United States of America**

- The 2017 Tax Cut and Jobs Act imposed a one-time mandatory repatriation tax on post-1986 deferred foreign income
- The taxpayers argue that income must be “realized” before it can be taxed, and thus the tax is unconstitutional
- The holding could have application beyond this statute



Questions?



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THANK YOU

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