



# Tax Briefs



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## News Update on Tax Issues from SLGG

SINGER LEWAK GREENBAUM & GOLDSTEIN LLP  
Certified Public Accountants & Management Consultants

*In each issue, we cover various tax issues of interest to individuals and businesses*

## IRS Targets Payments to Captive Insurance Companies

Prior to now it was thought that payments made to a “cell” within a captive insurance company should generally qualify as insurance. Qualifying as insurance is important if you want to deduct the premiums paid to the cell. And it’s just as important to the captive that these payments be treated as premiums. The IRS took up this matter recently in *Revenue Ruling 2008-8* and announced their position as to what type of cell arrangements might qualify as insurance.

Some captives are organized as a group of cells. A captive with cells is sometimes called a Protected Cell Company or PCC. A cell is not treated as a legal entity distinct from the PCC and the creator of the PCC owns all the common stock. Usually non-voting preferred stock is issued by each cell to its participant. The participant is the person that wishes to use the benefits of a captive. So basically each cell is funded by its participant’s preferred capital contribution and by the “premiums” collected for the contracts to which the cell is a party. Each cell is required to pay out claims on these contracts.

The income, expense, assets, liabilities, and capital of each cell are accounted for separately from those of any other cell and of the PCC generally. The assets of each cell are statutorily protected from the creditors of any other cell and of the PCC.

To qualify as insurance two requirements must be met. The first is risk shifting. Think of this as the premium payer’s requirement. The second is risk distribution. Think of this as the captive’s requirement.

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences to the insurer, such that a loss does not affect the insured because the loss is offset by the insurance payment. Risk distribution occurs when the party assuming the risk distributes its potential liability

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among others, at least in part.

A transaction between a parent and its wholly-owned subsidiary does not satisfy the requirements of risk shifting and risk distribution if only the risks of the parent are insured.

The IRS basically issued two rulings. In the first ruling, the IRS explained that if a cell is only insuring a single company then no insurance arrangement exists even though the PCC has a lot of other cells and insured parties. In the second ruling, the IRS ruled that insurance did exist when a cell insured twelve subsidiaries of its participant or in this case the parent of the subsidiaries because there was risk shifting and risk distribution. That is, the premiums were pooled such that a loss by one subsidiary was not in substantial part, paid from its own premiums.

If you are using a captive insurance company arrangement, it is important that you know whether you are the sponsor of a cell within the captive. Some earlier captives did not use cells; they simply pooled their resources with either other participants or with the subsidiaries of the sponsoring company. If you are using a cell arrangement it is important that you are insuring more than one or two or perhaps even three different subsidiaries or related companies. You should consult your tax advisor to determine if your payments qualify as insurance premiums in light of this most recent development.

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