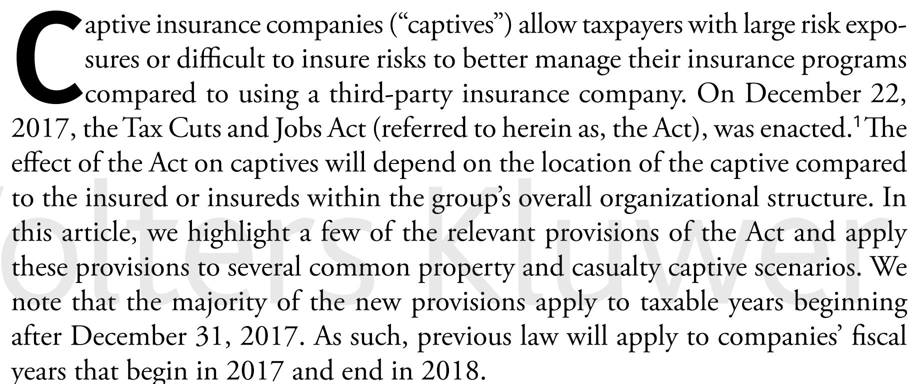
Insurance Perspectives

Effects of the Tax Cuts and Jobs Act of 2017 on Captive Insurance Companies

*By Thomas Cyr, Sheryl Flum and William Olver**



Captive insurance companies ("captives") allow taxpayers with large risk exposures or difficult to insure risks to better manage their insurance programs compared to using a third-party insurance company. On December 22, 2017, the Tax Cuts and Jobs Act (referred to herein as, the Act), was enacted.[1] The effect of the Act on captives will depend on the location of the captive compared to the insured or insureds within the group's overall organizational structure. In this article, we highlight a few of the relevant provisions of the Act and apply these provisions to several common property and casualty captive scenarios. We note that the majority of the new provisions apply to taxable years beginning after December 31, 2017. As such, previous law will apply to companies' fiscal years that begin in 2017 and end in 2018.

I. Background on Captive Insurance Companies

A captive insurance company, like other insurance companies, must meet certain requirements to qualify as an insurance company for federal tax purposes. First, the company must be engaged in the business of issuing contracts that are insurance or reinsurance contracts for U.S. federal income tax purposes. Second, the issuance of insurance or reinsurance contracts must represent more than half of the company's business.

Neither the Code[2] nor the regulations define the terms "insurance" or "insurance contracts." Instead, a body of authority has developed through court decisions and administrative pronouncements to define insurance. In general, these authorities outline four main characteristics of insurance. First, insurance must have insurance risk, that is, an unexpected risk of loss.[3] Second, insurance must shift risk from the insured to the insurer, particularly when the insurer becomes exposed to the economic risk of loss from an insurance event.[4] Although risk may generally not be shifted from a parent to its subsidiary (absent non-related party risk), risk may generally be shifted from one brother–sister entity to another brother–sister entity.[5] Third, insurance must distribute the potential risk of loss to the insurer by considering the risks of the underlying policyholders.[6] Courts have held that risk distribution occurs when an insurer insures a sufficient number of statistically

THOMAS CYR is a Partner in Tax, KPMG LLP, Boston, MA.

SHERYL FLUM is a Managing Director of Washington National Tax, KPMG LLP, Washington, DC.

WILLIAM OLVER is a Senior Associate in Tax, KPMG LLP, Boston, MA.

© 2018 KPMG LLP AND ITS AFFILIATES. ALL RIGHTS RESERVED.

independent risks considering both the diversity of risks assumed (*e.g.*, types and locations of risks) as well as the number of unique insured risks.[7] Fourth, insurance must satisfy the "commonly accepted notion of insurance" requirement.[8] Courts consider a number of factors as part of this criteria, including the treatment of the arrangement by regulatory authorities and the adequacy of the insurer's capitalization.[9] In addition to other business benefits, companies would prefer that their captive be treated as an insurance company for federal tax purposes. This is due to the fact that insurance companies can deduct a portion of their loss reserves currently, while similar reserves in the hands of a non-insurance company would not be deductible until the claims are paid.

The effect of the Act on captives will depend on the location of the captive compared to the insured or insureds within the group's overall organizational structure.

II. Law Changes

The Act does not provide any additional clarity for captive insurance companies as far as qualifying as a captive insurance company for federal tax purposes. The Act does, however, contain a number of provisions that will affect the taxation of captive insurance companies.

A) Domestic Law Changes

1. Rate Reduction

The most significant corporate tax reform is the reduction of the maximum corporate tax rate from 35 percent to 21 percent, effective for tax years beginning after December 31, 2017.[10] Accordingly, captives will pay 40 percent less tax on their income, to the extent such income is subject to U.S. tax and assuming no other changes to taxable income due to the Act. Similarly, the tax impact of deductions will decrease by 40 percent, including deductions for premiums paid to captives. As a general rule, the accelerated tax deduction of the loss reserves for a captive insurance company provides a cash-flow benefit for corporations setting up a captive. The decrease in the tax rate to 21 percent may also decrease the cash flow benefit of a captive. Any deferred tax assets or liabilities currently on a captive's financial statements would also need to be revalued at the lower 21-percent tax rate.

2. Net Operating Losses

Another major corporate reform is the change to the net operating loss ("NOL") rules. For tax years beginning before January 1, 2018, taxpayers were generally allowed to carry back NOLs two years and carry forward NOLs 20 years with no limitation on the amount of taxable income the NOLs may offset.[11] As a result of the Act, most taxpayers (including most corporations and life insurance companies) with tax years beginning after December 31, 2017, may no longer carry back NOLs but may carry forward NOLs indefinitely subject to an 80-percent limitation of the taxpayer's taxable income when the NOL carryforward is utilized.[12] The NOL rules for property and casualty ("P & C") insurance companies, however, have not changed.[13] In other words, P & C companies, including a captive insurance company treated as a P & C company, may still carry back NOLs two years and carry forward NOLs 20 years without limitation on the amount of taxable income the NOL may offset.

Because of the unique nature of the NOL rules for P & C companies, guidance will be needed to determine the proper utilization of NOLs when a P & C captive insurance company files as part of a consolidated return. For example, a consolidated group may exist where several non-P & C companies generated $500 taxable income for 2017 and no taxable income for 2018 and where a P & C company generated no taxable income for 2017 and a $1,000 NOL for 2018. As a whole, the consolidated group would be in a taxable position in 2017 and in a loss position in 2018. Under the new NOL rules, it is not clear if the $1,000 NOL generated by the P & C entity could be carried back to 2017 and offset the $500 of taxable income generated by the non-P & C entities. Although not discussed in the conference report accompanying the Act, the use of NOLs in this way may circumvent Congress's intent with the new NOL rules (*i.e.*, pre-tax reform taxable income may not be offset by post-tax reform losses).

3. Loss Reserve Calculation

Another notable change from the Act is the modification of the rules used to calculate loss reserves effective for tax years beginning after December 31, 2017. For P & C companies, loss reserves must be discounted using a 60-month corporate bond yield curve rather than the applicable mid-term federal rate that was used in the past.[14] Additionally, P & C companies are no longer allowed to make an election under Code Sec. 846(e) to use company-specific loss payment patterns; instead,

P & C companies must use industry-wide historical loss patterns.[15] This change will likely decrease the amount of loss reserves that a P & C company can deduct currently.[16]

4. Application of Domestic Law Changes to Captive Insurance Companies

- U.S. Sub makes payment to U.S. Captive that are both included as part of U.S. Group.

Premium payments paid by U.S. Sub to U.S. Captive will result in a deduction in the amount of the premium. U.S. Captive will recognize income in the amount of the payment with a corresponding deduction for the related reserve. Because of the new reserve calculation rules noted above, the amount of the deduction will likely be lower than in previous years. In other words, U.S. Captive will be required to recognize more income sooner than it may have previously. The deduction of U.S. Sub and the income of U.S. Captive would be included as part of U.S. Group's consolidated return. To the extent that the deduction for U.S. Sub occurs in Year 1 and a portion of the related income is recognized by U.S. Captive in Year 2, the consolidated return regulations allow this mismatch in consolidation.[17]

To the extent U.S. Group has an NOL and a portion of the NOL is attributable to U.S. Captive, that portion of the NOL may be carried back to offset taxable income in any of the two previous tax years. Without further guidance from the IRS, it is unclear whether such NOL may be carried back only to the extent U.S. Captive contributed to U.S. Group's taxable income in the previous two tax years or whether the NOL may be carried back to offset any of U.S. Group's taxable income, even if U.S. Captive generated no taxable income. Similarly, if the non-property and casualty group generates a loss due to the premium payment to the captive and the group is in a NOL, the loss of the non-insurance group will not be able to be carried back and will need to be carried forward and subject to an 80-percent taxable income limitation in the year utilized.

B) International Law Changes

The new or modified international law provisions of the Act may have significant effects on certain foreign captives, including those multi-national groups with foreign parents and U.S. entities. We highlight two notable provisions below.

1. Mandatory Repatriation

As part of the transition from the current deferred taxation of foreign income regime to the participation exemption regime (which will generally tax income as earned or else permanently exempt such income from U.S. taxation, *i.e.*, a territorial system of taxation), there will be a one-time mandatory inclusion of certain deferred earnings and profits ("E & P").[18] This mandatory inclusion will be taxed at a 15.5-percent rate to the extent it is attributable to the shareholder's aggregate foreign cash position (including cash and cash equivalents) and at an eight-percent rate on all other earnings.[19]

The mandatory inclusion applies to all U.S. shareholders of specified foreign corporations ("SFCs").[20] Under previous law, a U.S. shareholder generally included domestic corporations, partnerships, trusts, estates, and U.S. individuals that directly, indirectly, or constructively own 10 percent or more of a foreign corporation's voting power.[21] (Going forward, we note the definition of U.S. shareholder is expanded to include a U.S. person that owns 10 percent or more of the vote or value of a foreign corporation.)[22] As part of the Act, however, Code Sec. 958(b)(4) was repealed for the last tax year of foreign corporations beginning before January 1, 2018, and all subsequent tax years and for the tax years of a U.S. shareholder with or within which such tax years end. This change now allows "downward attribution" of stock ownership from foreign persons for purposes of determining whether a U.S. person is a U.S. shareholder of a foreign corporation for purposes of the mandatory inclusion.

> *Entities using foreign captives in particular must be mindful of potential mandatory repatriation implications for taxable years ended December 31, 2017, or fiscal years ending in 2018, as well as BEAT implications going forward.*

For example, if a domestic corporation owns nine percent of a foreign affiliate, and the remaining 91 percent of the foreign affiliate is owned by the domestic corporation's foreign parent, then the foreign affiliate is an SFC and the domestic corporation is a U.S. shareholder of the affiliate. Therefore, the domestic corporation would have to include its *pro rata* share of the foreign affiliate's deferred income, here nine percent of the E & P accrued during periods the foreign affiliate was an SFC based on its direct and indirect ownership of the foreign affiliate (*i.e.*, not considering the downward attribution from the foreign parent).

Wolters Kluwer

2. BEAT

The Act also implements a new base-erosion-focused minimum tax (the "base erosion and anti-abuse tax" or "BEAT") that in many cases will significantly curtail the U.S. tax benefit of cross-border related-party payments made by large multinationals.[23]

The BEAT generally applies to domestic corporations that meet certain requirements: 1) the domestic corporation is not taxed on a flow-through basis (*i.e.*, is not taxed as an S corporation, regulated investment company, or real estate investment trust); 2) the domestic corporation is part of a group with at least $500 million of annual domestic gross receipts over a three-year averaging period (including effectively connected amounts earned by foreign affiliates); and 3) the domestic corporation has a "base erosion percentage" of three percent or higher for the tax year.[24] The BEAT also applies to foreign corporations engaged in a U.S. trade or business for purposes of determining their effectively connected income tax liability.[25] Payments possibly subject to the BEAT generally include amounts paid or incurred by the taxpayer to foreign related parties for which a deduction is allowable.[26] Related parties generally include a 25-percent owner or entities that are related under Code Sec. 267(b), 707(b)(1), or 482.[27]

The BEAT is equal to 10 percent (five percent in years beginning in 2018[28] and 12.5 percent beginning after 2025[29]) of a company's modified taxable income, which in general is equal to regular taxable income with base erosion payments added back. The company's tax liability is the higher of 10 percent of modified taxable income or the regular tax liability.

Nearly every payment made by a domestic corporation meeting the above-listed requirements to a related foreign party may be subject to the BEAT (except for payments treated as cost of goods sold or otherwise treated as reductions to gross receipts, subject to regulatory authority for the Secretary to write anti-avoidance regulations). Of particular relevance to captives, the Act also specifically includes a provision that the BEAT applies to cross-border reinsurance payments. This category includes any premium or other consideration paid that is taken into account as a reduction in either life insurance gross income under Code Sec. 803(a)(1)(B) or insurance company taxable income under Code Sec. 832(b)(4)(A).

We note that the BEAT would not apply to any payments made to captives that elect to be treated as domestic corporations under Code Sec. 953(d) because such payments would be treated as being made to a domestic related party.

3. Application of International Law Changes to Captive Insurance Companies

- Scenario One: U.S. Corp makes payment to Foreign Captive that is treated as an insurance company for federal tax purposes.[30]

In Scenario One, U.S. Corp would be entitled to an immediate deduction for payments made to Foreign Captive. All premium payments from U.S. Corp to Foreign Captive would be subject to the BEAT if the requisite thresholds were met because the premium payments would give rise to a deduction for U.S. Corp and because U.S. Corp and Foreign Captive are related parties. In other words, to the extent that the domestic gross receipts for the multinational group including U.S. Corp exceed $500 million and the base erosion percentage is three percent or greater, then any amounts paid by U.S. Corp to Foreign Captive would be subject to the BEAT.

The insurance payments made to the captive would be included with any other BEAT payments made between the U.S.-insured entity and any other foreign-related party. Premium payments from U.S. Corp to Foreign Captive are also subject to a federal excise tax under Code Sec. 4371 ("FET") of four percent (for premiums for non-life insurance) or one percent (for premiums for reinsurance).

We note that the BEAT may apply in this scenario, even if the Foreign Captive's income is fully included as Subpart F income to U.S. Group. In this way, it is possible for a portion of the premium payments from U.S. Subs to Foreign Captive ultimately to be subject to a maximum tax rate of greater than 21 percent.

Additionally, for the taxable year ended December 31, 2017 (or the first taxable year ended in 2018 if U.S. Corp has a fiscal year), U.S. Corp may be subject to the mandatory repatriation provisions of the Act if U.S. Corp had an ownership interest in Foreign Captive. For example, the mandatory repatriation provisions would apply even if U.S. Corp only had a one-percent ownership interest (directly or indirectly) in Foreign Captive, and U.S. Corp's foreign parent owned the remaining 99 percent. Under these facts, Foreign Captive would be treated as an SFC as a result of downward attribution of the ownership of Foreign Captive from U.S. Corp's foreign parent to U.S. Corp, and U.S. Corp would be taxed on one percent of Foreign Captive's previously untaxed E & P.[31]

- Scenario Two: U.S. Corp makes payment to Foreign Captive that is not treated as an insurance company for federal tax purposes.

In Scenario Two, U.S. Corp would not be entitled to a deduction when payments are made to Foreign Captive

because such payments are not treated as deductible insurance payments. Similarly, because the payments are not considered to be insurance for federal income tax purposes, the FET would not apply. To the extent losses were ultimately recognized by U.S. Corp once claims were paid, then U.S. Corp would be entitled to a deduction at that point.

For the taxable year ended December 31, 2017 (or the first taxable year ended in 2018 if U.S. Corp has a fiscal year), U.S. Corp may be subject to the mandatory repatriation provisions of the Act if U.S. Corp wholly owned Foreign Captive. In this case, Foreign Captive would be treated as an SFC, and U.S. Corp would be taxed on Foreign Captive's previously untaxed E & P. We note that Foreign Captive's E & P in this scenario already may have been treated as Subpart F income to U.S. Corp (*i.e.*, previously taxed to U.S. Corp). If so, then the mandatory repatriation provisions would not result in any additional tax due by U.S. Corp.

Because the payments are not treated as insurance, the payments from U.S. Corp to Foreign Captive would not give rise to deductions. Accordingly, the payments from U.S. Corp to Foreign Captive would not be subject to the BEAT even if the domestic gross receipts for U.S. Corp exceeded $500 million.

One common example of this scenario involves tax-exempt entities, such as healthcare organizations. Typically, these entities treat payments to their foreign captives as contributions to capital, which are not deductible to the payor entity and not included in the foreign captive's income under Code Sec. 118. Initially, the House proposed to repeal Code Sec. 118 and generally treat contributions to capital as includible in gross income. However, the Act did not adopt the House's proposed language and instead modified the definition of contributions to capital under Code Sec. 118, which the conference agreement explained as follows:

> [T]he term "contributions to capital" does not include (1) any contribution in aid of construction or any other contribution as a customer or potential customer, and (2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

Accordingly, contributions to capital to tax-exempt entities likely would not generate any income or E & P for a foreign captive. Even if the foreign captive were to generate E & P, it is likely that any of the foreign captive's E & P attributable to the tax-exempt entity would be treated as tax-exempt Subpart F income to the tax-exempt entity. Overall, it is unlikely that the change to Code Sec. 118 will impact tax-exempt entities that utilize captives in this manner.

- Scenario Three: Foreign Captive treated as a group captive with 20 unrelated U.S. owners, all of which own less than 10 percent of Foreign Captive by vote or by value.

Under Scenario Three, as with Scenario One, any payments made by the U.S. owners to Foreign Captive would be immediately deductible and subject to the FET. Unlike Scenarios One and Two, however, there are probably no mandatory repatriation or BEAT implications to the U.S. owners in this scenario. With respect to the mandatory repatriation provisions, Foreign Captive would not be treated as an SFC because no single owner owns 10 percent of Foreign Captive either directly, indirectly, constructively, or through downward attribution of a related entity. Even though the payments from the U.S. owners to Foreign Captive are deductible, the U.S. owners and Foreign Captive are not "related" as defined for purposes of the BEAT (*i.e.*, a 25-percent owner of the captive or otherwise related within the meaning of Code Secs. 267(b), 707(b)(1), or 482), and therefore the payments would not be subject to the BEAT.

These considerations, as well as FET and state premium and self-procurement taxes, are important to account for when analyzing the tax implications of a captive.

Wolters Kluwer

III. Summary

As discussed above, the Act did not have any sections that were specific to captive insurance companies; however, the changes to the Code promulgated by the Act may have an important impact on captives, depending on the particular relationship between the insured and the captive. Entities using foreign captives in particular must be mindful of potential mandatory repatriation implications for taxable years ended December 31, 2017, or fiscal years ending in 2018, as well as BEAT implications going forward. These considerations, as well as FET and state premium and self-procurement taxes, are important to account for when analyzing the tax implications of a captive.

ENDNOTES

* The authors can be reached *via* mail at *tcyr@kpmg.com*, *sflum@KPMG.com* and *wolver@kpmg.com*.

[1] H.R. 1, 115th Cong., 131 Stat. 2054 (2017) (enacted).

[2] All references to "Code Sec.," "§", or "Code" refer to the Internal Revenue Code of 1986, as amended to date, unless otherwise noted.

[3] *See, e.g.*, *Allied Fidelity Corp.*, CA-7, 78-1 USTC ¶9325, 572 F2d 1190, 1193; *M.F. Treganowan*, CA-2, 50-1 USTC ¶10,770, 183 F2d 288, 290–291.

[4] *See, e.g.*, *Humana Inc.*, 88 TC 197, Dec. 43,666 (1987), *aff'd in part and rev'd in part*, CA-6, 89-2 USTC ¶9453, 881 F2d 247.

[5] *See, e.g.*, *Kidde Industries, Inc.*, FedCl, 98-1 USTC ¶50,162, 40 FedCl 42 (1997); *Hospital Corp. of America*, 74 TCM 1020, Dec. 52,320(M), TC Memo. 1997-482; *see also* Rev. Rul. 2002-89, 2002-2 CB 984 (concluding an arrangement with less than 50-percent parental risk may constitute insurance whereas an arrangement with greater than 90-percent parental risk may not constitute insurance); Rev. Rul. 2002-90, 2002-2 CB 985 (concluding insurance may exist when a captive insures at least 12 brother–sister entities and the percentage of insurance risk in the captive for any single entity was between five and 15 percent).

[6] *See, e.g.*, *Rent-A-Center*, 142 TC 1, Dec. 59,801 (2014); *Humana Inc.*, CA-6, 89-2 USTC ¶9453, 881 F2d 247; *M.F. Treganowan*, CA-2, 50-1 USTC ¶10,770, 183 F2d 288.

[7] *See, e.g.*, *Rent-A-Center*, 142 TC 1, Dec. 59,801 (2014); *Securitas Holdings, Inc.*, 108 TCM 490, Dec. 60,068(M), TC Memo. 2014-225.

[8] *See, e.g.*, *Rent-A-Center*, 142 TC 1, Dec. 59,801 (2014).

[9] *See, e.g.*, *Rent-A-Center*, 142 TC 1, Dec. 59,801 (2014).

[10] H.R. 1, §13301.

[11] Code Sec. 172.

[12] H.R. 1, §13302(a), (b), (e).

[13] *Id.*, §13302(d).

[14] H.R. 1, §13523.

[15] *Id.*

[16] To the extent this new provision affects reserves for contracts issued on or before December 31, 2017, any corresponding adjustments may be accounted for ratably over the succeeding eight tax years.

[17] Reg. §1.1502-13(e)(2)(ii)(A).

[18] H.R. 1, §14103.

[19] *Id.*

[20] We expect that many U.S. taxpayers with foreign captives will not be subject to mandatory repatriation, however. As a general rule, because of Subpart F and the FET, most captives owned by a domestic parent company have previously made a Code Sec. 953(d) election to be taxed as a U.S. entity.

[21] Code Sec. 958.

[22] H.R. 1, §14214.

[23] H.R. 1, §14401.

[24] *Id.*

[25] *Id.*

[26] *Id.*

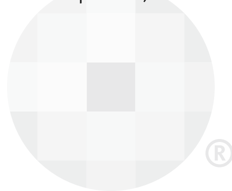
[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] This discussion generally applies whether U.S. Corp is the ultimate parent entity, a subsidiary of a domestic ultimate parent entity, or a subsidiary of a foreign ultimate parent entity.

[31] In practice, for a case where U.S. Corp has a foreign parent and the foreign parent has an ownership interest in Foreign Captive, U.S. Corp does not typically also have an ownership interest in Foreign Captive. That is, either the mandatory repatriation provisions would apply because U.S. Corp has a greater than 10-percent ownership interest in Foreign Captive, or the mandatory repatriation provisions would not apply because U.S. Corp has no direct or indirect ownership interest in Foreign Captive.



Wolters Kluwer

This article is reprinted with the publisher's permission from the Journal of Taxation of Financial Products, a quarterly journal published by Wolters Kluwer. Copying or distribution without the publisher's permission is prohibited. To subscribe to the Journal of Taxation of Financial Products or other Wolters Kluwer Journals please call 800 449 8114 or visit CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of Wolters Kluwer.