Paper Title: Captives in 2020 and Beyond

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Session Title:
Changes in the Landscape for Captive Insurance: Court Cases, Tax Reform & Recent IRS Guidance

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Changes in the Landscape of Captive Insurance Companies: Court Cases, Tax Reform and Recent IRS Guidance

I. BACKGROUND.

Many businesses have found the commercial insurance market to be inadequate in addressing risk management issues. This has led to many businesses to establish affiliated “captive” insurance companies. Initially those insurance companies only insured affiliated risks, but have since expanded to insure unaffiliated risks; typically, those risks have some connection with the business of the insured and/or the entity that is managing the captive insurance company. In the construction industry, insurance programs have been established by the Owner of a development, or by the General Contractor, to provide insurance to all the subcontractors of the project. These programs are called “OCIPs” or “CCIPs” (owner-controlled insurance programs and contractor-controlled insurance programs and contractor controlled insurance programs, respectively.) The theory is that if an accident on the jobsite, a single insurance company will respond, and that economies of scale can be gained. These programs are sometimes conducted through a captive, at least in part.

Since 1976, the IRS has been active in the taxation of captive insurance arrangements. It originally stated that no related party insurance arrangements were insurance for Federal income tax purposes (Rev. Rul. 77-316, 77-2 C.B. 53), no matter how they were structured. The IRS then won several cases in the Courts, before they lost a series of case in the late 1980’s to early 1990s, Humana Inc. and Subsidiaries v. Commissioner, 881 F.2d 247 (6th Cir. 1989) rev’g in part, aff’g in part, 88 T.C. 197 (1987), Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 861 (7th Cir. 1992), aff’g on the captive issue, 96 T. C. 61 (1991), Amerco and Subsidiaries v. Commissioner, 96 T. C. 18 (1991), aff’d 979 F.2d 162(9th Cir. 1992), The Harper Group and Includible Subsidiaries v. Commissioner, 96 T. C. 45 (1991), aff’d 979 F.2d 1341 (9th Cir. 1992), and Ocean Drilling & Exploration Company v. United States, 24 Cl. Ct. 714 (1991); aff’d per cur., 988 F. 2d 1135 (Fed. Cir. 1993). In 2001, the IRS abandoned its position, and stated that a captive insurance arrangement could be insurance for tax purposes, if it were properly structured. Rev. Rul. 2001-31, 2001-1.C.B. 1348. In 2002, the IRS issued a trilogy of rulings setting out permissible parameters for captive insurance arrangements. Rev. Rul. 2002-89, 2002-2 C.B. 984; Rev. Rul. 2002-90, 2002-2 C.B. 985; and Rev. Rul. 2002-91 2002-2 C.B. 991. Since then, the IRS has been “narrowing the strike zone”.

The most recent litigation involves small captive insurance companies that receive additional benefits under sections 501(c)(15) and 831(b). Avrahami v. Commissioner, 149 T.C. 144 (2017); Reserve Mechanical Corp. v. Commissioner, TC Memo 2018-86; and Syzygy Insurance Co., Inc. v. Commissioner, TC Memo 2019-34. This litigation has focused on the “risk distribution” and “common notions of insurance” tests discussed below. The IRS has been successful in these three cases, and some of the reasoning has been very surprising to tax lawyers. Even though they relate to small insurance companies taxed under specific statutes,
their holdings are applicable to larger captives and are important to all captives. [Section references in this article are to the Internal Revenue Code.]

This article addresses recent developments in the context of the tax tests for insurance. It is written primarily for a single parent captive that is either a domestic (U.S.) captive, or one that elects under section 953(d) to be taxed as a U.S. captive.

II. BACKGROUND TAX PRINCIPLES.

A. General Background.

For most business transactions, the payer gets a deduction for its payment and the recipient reports income. Thus, if a business (for instance, a contractor) buys insurance from Travelers, the business gets a deduction and Travelers has income. Section 162 and Treas. Reg. 1.162-1.

B. Deductions for Claims and Reserves.

If the contractor self-insures its products liability exposure, it can only deduct its damage payments when made. However, an insurance company can immediately deduct the present value of that payment by establishing a reserve for losses. Accordingly, if a contractor statistically knows it will pay a $1,000,000 liability claim in 10 years, the contractor deducts the actual amount of the payment in year 10. However, an insurance company selling insurance for that same risk can deduct the present value of the $1,000,000 in years 1, then adjusts that amount in each successive year. If a contractor could validly set up its own captive insurance company, the captive could gain a tax advantage by deducting most of the loss much earlier.

People often talk about the deductibility of premiums as the benefit of a captive insurance arrangement. But the true benefit is the acceleration of the deduction of the reserves for losses. The insured gets a deduction for premiums paid, but the insurance company has income by the same amount; these offset, but the insurance company also gets a deduction for the reserve for losses which the insured would not have received if it had self-insured the risks. Depending on the facts, and accounting methods, the premium payment and insurance income may not occur in the same taxable year. There are also aspects of the computation of taxable income for an insurance company that are beyond the scope of this article. Strictly from a mathematical standpoint, there is more tax benefit from longer-tailed coverages because there is a larger difference between the time that an insurance company would get a deduction for the reserve, and when a self-insured contractor would get a deduction for the actual payment of a self-insured claim. As noted below, this discussion does not fully apply to an insurance company taxed under sections 501(c)(15) or 831(b).

C. Fundamental Principles of Establishing a Captive.

A captive should only be formed only (1) for non-tax business reasons; (2) if the owners want to be in the insurance business (willing to assume and share risk); and, (3) if the captive is operated as an insurance company (including observing the formalities and operating at arm’s length with its affiliates).
D. Preliminary Matter – Business Purpose/Non-Sham.

Many of the court cases discuss whether the parties have entered into the captive arrangement for sufficient non-tax business purposes. Other cases evaluate whether the arrangement is a sham: either (1) it is entered into only for tax reasons, (2) it has bogus (or no) documents or (3) implementation strays too far from the documents. See, e.g., Humana and Ocean Drilling.

III. THE TAX TESTS.

Neither the Internal Revenue Code, nor the Treasury regulation define "insurance". It has been left to the courts to define it. The courts have generally found four items are required: (1) the risk insured must be an insurance risk; (2) the risk must be shifted; (3) the risk must be distributed; and (4) the risk arrangement must be insurance in its commonly-accepted sense. See, e.g., Sears, Amerco and Harper Group. Some courts combine the second and third criteria: risk shifting and risk distribution.

A. Insurance Risk.

First, an insurance risk must be a risk. A risk is one where there is a chance that the event may occur (there may be a fire), but there must also be a chance that it will not occur within a certain time and amount.

An insurance risk is a risk where there is no chance of gain: either there is a loss or a neutral outcome; for instance, a fire occurs (loss) or does not (neutral). This is unlike an investment risk where one may gain, lose or remain the same – stocks may rise, fall or remain the same.

The IRS also distinguishes between a business risk and an insurance risk. The IRS has not done much to define a business risk. It has said that an imbedded warranty is not an insurance risk. An imbedded warranty is included in the purchase price, cannot be declined, and is, in some respects, required by law (and is often provided by the contractor or retailer.) CCA 200628018 (7/14/06). In contrast, the IRS views an extended warranty as an insurance risk. CCA 200631002 (8/14/06); see also, PLR 200811009 (11/5/07). The IRS stated that residual value insurance was not an insurance risk, but the Tax Court ruled that it is, in R.V.I. Guaranty, Ltd. v. Commissioner, 145 T.C. 209 (2015); see also, CCA 201802014 (10/6/17) where the IRS loosened its view on currency fluctuation after R.V.I. While other cases may recite the coverages (e.g. Avrahami), none addresses it like R.V.I.

The working assumption has been that surety bonds are insurance for tax purposes (surety bonds provide that the surety has recourse against the contractor, thus raising the question as to whether the contractor shifted the risk. An alternative product is sub-contractor default (generally, known as “sub-guard”), which is sold in the commercial market.
B. Risk Shifting.

Risk shifting means that the risk of loss is shifted from the insured to the insurer. Rev. Ruls. 2002-89 and 2002-90. If a loss occurs, the insurance company will bear the financial consequences of that loss and the insured will be financially unaffected. Where the parent corporation owns, and is insured by, the captive, the courts have held that the risk cannot be shifted unless the captive also insures sufficient unrelated business.

Risk shifting can be illustrated by the following example. If I purchase car insurance, I have shifted the financial consequences to the insurance company. Strictly from a financial standpoint, I am indifferent to whether I wreck my car, because the insurance company will repair my car or supply me with a replacement car.

The captive should be adequately capitalized in order to attain risk shifting.

Early cases found that insurance was not achieved where the obligations of the insurance company were guaranteed by the insured or an affiliate. See, e.g., Malone & Hyde v. Commissioner, 62 F.3d 835 (6th Cir. 1995), rev’g TC Memo 1993-585, reconsidering, TC Memo 1989-604; Hospital Corporation of America v. Commissioner, TC Memo, 1997-482; and Kidde Corporation v. United States, 40 Fed. Cl. 42 (1997). In 2014, Rent-A-Center v. Commissioner, 142 T.C. 1 (2014) and Securitas v. Commissioner, TC Memo 2014-225 involved guarantees, but insurance was present under those facts. The safe approach is to avoid guarantees.

C. Risk Distribution.

1. Background. Where related parties are involved, the IRS has found that there is risk shifting and risk distribution in two scenarios: sufficient outside unrelated business and “brother-sister”, see Rev. Rul. 2002-89 and 2002-90, respectively.

Risk distribution has two different aspects to it. Risk distribution means that there is the “pooling” of premiums relating to a sufficient number of risks that the “law of large numbers” operates.

2. Law of Large Numbers. The “law of large numbers” means that there are sufficient risks that the law of averages will result in the overall loss being about what is predicted. It is easy to see this if we apply it to flipping a coin. If you flip a coin 10 times, you should average 5 heads and 5 tails, but the results could vary widely. If you flipped it 1,000,000 times, you would anticipate that the results would be very close to 500,000 heads and 500,000 tails. Applying this to insurance, suppose it is anticipated that 20% of 85-year olds will die within a year. If one insured 10 85-year olds, then it would be anticipated that 2 would die; if only 1 died or 3 died, that would be a 50% deviation from the anticipated. If, however, one insured 1,000,000 85-year olds, it would be anticipated that 200,000 died. If 190,000 or 210,000 died, that would be a deviation of 5%.

3. Pooling of Premiums. In addition to the “law of large numbers”, a “pooling” of premiums is required. The IRS has said that this “pooling” results from premiums from a number of insureds and not just result from premiums for a number of risk exposures. For instance, this would mean that even if one bought a workers’ comp policy on 1,000,000
employees dispersed throughout the nation, the IRS would say that there could not be risk distribution if they were employed by a single corporation (or two corporations with one representing 90% of the risk), even if the insured and insurer were unrelated. Rev. Rul. 2005-40.

4. **Unrelated Business.** The IRS (and the courts) have generally found that a parent corporation cannot shift risk from itself to a wholly-owned insurance company, unless there is sufficient outside business. The IRS ruled that if there is only 10% outside business the parent premiums are not insurance; if there is more than 50% outside business the parent premiums are insurance. Rev. Rul. 2002-89. The Tax Court and Ninth Circuit in Harper Group found there was insurance where one of the years was 29% outside business (in *Sears*, the unrelated percentage was over 99%, in *Amerco*, over 50%, and in *Ocean Drilling*, 44% in the lowest year).

5. **Risk Pools.** The IRS has informally ruled that each of the three types of pools will produce risk distribution, if properly done. *See, e.g.*, PLRs 200844011, 200907006, 200950016, 200950017, 201030014, 201219009, 201219010, 201219011 and 201224018. These private rulings are not precedential. In *Avrahami, Reserve Mechanical, and Syzygy*, the Tax Court stated that in order for risks to be considered in determining if a captive has risk distribution, the pooling entity must be an insurance company for Federal income tax purposes. The industry is surprised that this is required; the industry would have thought that if a captive is liable for an unrelated claim, then it is irrelevant whether the risk is assumed directly from the insured, or from a state law insurance company (regardless of whether that entity is an insurance company for tax purposes or not); *see, e.g.*, Rev. Rul. 2009-26 for the general concept that one looks through the pooling entity to ultimate insureds [although in this Revenue Ruling, the pooling entity is an insurance company for tax purposes.] In addition, in *Avrahami, Reserve Mechanical, and Syzygy*, the Tax Court expressed surprise that the premiums paid to the pooling entity to assume the risk, were equal (subject to ceding commission) to the premiums paid by the pooling entity to have the risk assumed. The industry believes that not only is this a permissible way to operate a pool, but it is the only way. *See, e.g.*, Commercial Insurance and Captive Insurance Industry – Commonly Accepted Practices (1/31/19).

6. **OCIPs and CCIPs.** As stated above, contractors and subcontractors often participate in OCIPs and CCIPs. There is no authority for the treatment of these programs, but one question is whether premiums paid by (or, possibly, paid for) a subcontractor is third-party (unrelated) premium. Similarly, assuming that it is an insurance risk, is “sub-guard” unrelated premium?

7. **“Brother-Sister”.** Where the parent is not an insured, but rather the insurance subsidiary insures operating subsidiaries of the same parent, the courts have found that insurance exists. *Humana, Kidde* and *Hospital Corp*. The IRS has ruled that if one insures 12 subsidiaries each with between 5 and 15% of the risks, that insurance exists (Rev. Rul. 2002-90); if one insures only one subsidiary or two subsidiaries with one having 90% of the risks, insurance does not exist (Rev. Rul. 2005-40).

8. **Exposure Units.** Twice in 2014, in the *Rent-A-Center* and *Securitas* cases, the Tax Court seemed more concerned with exposure units (number of employees, stores, vehicles, etc.) than it was interested in the concentration of a majority of the premiums in one
operating subsidiary, with the remainder of premiums coming from a few other insureds. The recent *Avrahami* case, said, in one context, that the number of exposure units was more important than the number of entities

9. **Disregarded Entities.** The IRS has said that single member LLCs that are "disregarded entities" for income tax purposes are not counted as insureds; if these same LLCs elect to be taxed as corporations, they will be treated as insureds. Rev. Rul. 2005-40. The IRS has informally said that a multi-member LLC (and not its members) is the insured, and each general partner is the insured for a limited partnership according to informal IRS documents. TAM 200816029 (12/3/07); see also, CCAs 200952060 and 200952061.

10. **Group Captives.** As noted below, generally group insurers meet the insurance tests if none of the insureds has too much vote, equity and premiums (the IRS uses 15% as its safe harbor), and the facts are otherwise "plain vanilla.” Rev. Rul. 2002-91.

D. **Common Notions of Insurance.**

In the leading case on what constitutes insurance (not just captive insurance), the U.S. Supreme Court noted that neither the Internal Revenue Code, nor the Treasury regulations, define insurance. *Helvering v. LeGierse*, 312 U.S. 531 (1941). Accordingly, the Supreme Court stated that in determining if a transaction is insurance, the transaction must be insurance in its commonly accepted sense. This is sometimes referred to as “common notions of insurance”.

Many of the early cases did not discuss this aspect much, but *Avrahami, Reserve Mechanical*, and *Syzygy* each identified seven aspects in determining if an arrangement was insurance for tax purposes: (1) established, operated and regulated as an insurance company; (2) adequate capitalization; (3) valid and binding insurance policies; (4) reasonable premiums from an arms-length transaction; (5) claims were paid. *Avrahami* identified, but did not discuss, two additional aspects: whether the policies covered insurance risks and whether there was a legitimate business reason for acquiring insurance from the captive. These cases found that the captives were established and regulated as insurance companies, that they had adequate capitalization (since they met the domicile’s minimum capitalization) and that claims were paid. The cases generally found the captive arrangement wanting in the areas of operating like an insurance company, valid and binding policies and the reasonableness of the premiums.

Many factors could be imbedded in the requirement that a captive be “operated” as an insurance company. For instance, in *Avrahami*, the Tax Court found that the captive was not operated as an insurance company, in part, because the captive loaned money to a company owned by the children of the captive’s owner; the loans were a substantial percentage of the captive’s net worth and did not require principal or interest payments for several years. Similarly, in *Syzygy*, the captive was held not to operate as an insurance company when half of its assets were used to purchase life insurance that was not owned by the captive; moreover, the captive could not obtain the cash surrender value without the approval of a person that the Court did not think would give approval.

Other factors that the Court cited in these three cases in reaching its conclusions include, among others: the insured did not file claims until after the audit started (*Avrahami*); the insured did not file $100,000 of claims because the principal was too busy (*Syzygy*); the principal would
“freak out” if the captive lost money in the pool (Avrahami); expensive captive coverage was added to, and did not replace, inexpensive commercial coverage (Syzygy).

The Courts have been very skeptical of the pricing of the premiums. In Avrahami the Court did not accept the actuary’s explanation of the premium computation. In Syzygy, an actuary did not determine the premiums. The taxpayer did not prove why the captive coverage was more expensive than the commercial coverage, and did not prove why the premiums allocated to the pool coverage were proper.

Insurance regulation could also be a factor; the Treasury regulations state that while insurance regulation is important, what is determinative is how the captive is actually operated. Treas. Reg. 1.801-3.

IV. SECTIONS 831(b) AND 501(c)(15).

A. Section 831(b) Election.

1. Effect of the Election.

Most insurance companies are taxed under section 831(a) of the Internal Revenue Code. Qualifying companies can elect to be taxed under section 831(b), which provides that the insurance company will be taxed only on its net investment income. It will not be taxed on its insurance income. Thus, a captive will be taxed on investment income (dividends, interest, rents, royalties, capital gains and losses, non-insurance business income, etc.) less investment expenses and a very limited amount of overhead. The captive does not have to pay tax on its premium income, nor does it get a deduction for underwriting expenses, claims payments, reserves or the remainder of the overhead. The owner of the captive is taxed on distributions when received.

There are numerous potential downsides to the election: it is irrevocable without the IRS Commissioner’s consent; any net operating loss cannot be carried over or back; a net operating loss in a section 831(a) year could not be carried through a section 831(b) to another section 831(a) year; and, investment income is now subject to two levels of tax (investment income is taxed both at the captive level, and will be taxed again to the owner when it is distributed from the captive.)

2. Qualifying for the Election.

A property and casualty insurance company can make the election if (a) the greater of the direct written premiums or net written premiums does not exceed $2,300,000 (in 2019 and indexed in future years), and (b) the arrangement meets at least one of two diversification tests.

The first of the diversification tests is that no policyholder (including affiliates) represents more than 20% of the greater of the direct written or net written premiums. The second diversification test essentially states that the arrangement cannot both provide an income tax benefit and an estate tax benefit. This is accomplished by requiring that lineal descendants (children, step-children, children-in-law, grandchildren, etc.) and non-U.S. citizen spouses, cannot own a greater percentage in the insured assets than the percentage owned in the captive (there is a 2% de minimis differential that the IRS can adjust.) The IRS has not given further guidance as to how to compute these percentages where there are multiple insureds.
3. IRS Audits of Small Captives.

For the last few years, the IRS has been aggressively auditing small captives (both those taxed under section 831(b) and section 501(c)(15)) and has investigated certain captive managers for tax shelter promotion.

In 2015, and several years thereafter, the IRS has questioned whether those involved with a section 831(b) captive are involved with a tax shelter (the so-called “Dirty Dozen” list.) IRS 2015-19, 2016-25, 2017-31, 2018-62 and 2019-47. In Notice 2016-66, the IRS identified most section 831(b) arrangements as “Transactions of Interest.” This applied to captives who had loan-backs, etc. to affiliates or had less than a 70% loss ratio, with a five-year lookback. As a Transaction of Interest, participating captives, insureds, and, for pass-through entities, owners of insureds, must file a Form 8886 (and material advisors had their own filings.) There are further consequences to being a Transaction of Interest relating to, among other things, penalties and interest.

In IR-2019-157, the IRS announced a settlement initiative whereby it would extend settlement offers to up to 200 taxpayers who had captive insurance arrangements under examination, but no prior years in court. The IRS stated that such a settlement initiative would require substantial concessions and penalties, although those penalties could be eliminated if the taxpayer properly relied upon a tax advisor. If a taxpayer did not accept the offer, then the audit would continue, and the maximum adjustments and penalties could be imposed. The IRS Examination division issued this document and alleged that the independent Office of Appeals believed that the offer generally reflected the hazards of litigation (i.e., it was a reasonable deal.)

4. Litigation and Penalties.

As stated throughout this article, the IRS has won three small captive cases: Avrahami, Reserve Mechanical and Syzygy. At this writing, two other cases have been tried and are awaiting opinion. The latest “Dirty Dozen” release, IR-2019-47 states that there are 500 docketed cases in the Tax Court relating to captives (which would include the dockets of the insured or its owners), so that does not mean the there are 500 captives in court.

In Avrahami and Syzygy, the Courts did not impose a penalty because the taxpayers relied on tax professionals and that the guidance on captive insurance taxation was unclear. The Court did not discuss penalties in Reserve Mechanical, the implication of which is that no penalties were proposed.

B. Section 501(c)(15).

A captive that meets the requirements of section 501(c)(15) is tax exempt, meaning it pays no income tax on any of its income (investment or insurance income.) To qualify, the consolidated group of corporations cannot have more than $600,000 of gross receipts, and premiums must represent more than 50% of the gross receipts. There is a special rule for mutual insurance companies. Reserve Mechanical involved a captive under section 501(c)(15).

V. CONSEQUENCES OF A FAILED INSURANCE ARRANGEMENT.

A. Deduction.
If the premium is paid for an arrangement that is not insurance for tax purposes, it is not deductible as an insurance deduction. Syzygy states that such a payment may, nonetheless, be deductible as an ordinary and necessary indemnification payment. Because the insured did not file claims for $100,000 of claims, the Tax Court determined that the insured did not treat the agreement as an indemnification agreement, and thus, the payments were not deductible as non-insurance payments for an indemnification agreement.

B. Double Taxation.

In Syzygy, the Tax Court found that the arrangement was not insurance, and was not an indemnification agreement. The IRS had asserted that the disallowed premiums were also income to the captive. The taxpayer cited Rev. Ruls. 2005-40 and 2008-8 that if an arrangement is not insurance because of a lack of risk distribution, it is usually an indemnification agreement, a deposit, a loan or a capital contribution (to the extent of the value), or otherwise. None of the enumerated options would result in simultaneous taxation of both sides of the transaction. The Court further stated that the Revenue Rulings were admissions by the Government. Notwithstanding this, the Tax Court taxed the premiums to the captive because the captive did not prove why the premiums were not taxable.

VI. GROUP CAPTIVES.

In 1977, in Rev. Rul. 77-316, the IRS stated its official position that captive insurance does not “work” in a related party context, no matter how it is arranged. But almost simultaneously, in 1978, in Rev. Rul. 78-338, the IRS ruled that a group captive was a valid arrangement, where there were 31 participants and no single insured accounted for more than 5% of the total risks. The IRS has loosened its position on group captives; the current position is that there is insurance in a group captive, if no participant owns more than, represents more premium than, or has more vote than, 15%, and everything else is “plain vanilla”. Rev. Rul. 2002-91. Issues could arise, however, if (instead of each participant bearing a pro-rata share of the claims) the arrangement was structured so that the insured (or its owners) bear a disproportionate amount of claims of its affiliates. There is little direct authority on this.

VII. TAXATION OF CELLS AND SERIES TRANSACTIONS.

A. Taxation by Cell-by-Cell or by Company Wide.

A cell company is a single corporation within which there are numerous divisions (called cells), each of which has limited liability; that means that creditors of Cell “A” can only look to the assets of Cell A for repayment, and not to the assets of any other cell (or the core, unless the core consents.) Similarly, a series LLC is a single LLC within which there are numerous divisions (called series), each of which has limited liability. The question is whether tax is imposed upon each cell individually, or whether it is imposed on a company-wide basis.

In 2008, the IRS ruled that to determine whether a transaction between an insured and a
cell-insurer is insurance, is determined on a cell-by-cell basis. Rev. Rul. 2008-8. Thus, one
determines if the tax tests described above (insurance risk, risk shifting, risk distribution and
insurance in its commonly accepted sense) are met, by looking exclusively as to what goes on
inside the cell (and not the circumstances throughout the entire cell company.) If it is
determined that there is insurance by looking only within the cell, then the premium paid is
deductible.

C. Taxation of the Cell or Series.

In 2010, the Treasury issued proposed regulations that stated that each U.S. cell and series
will be taxed as a separate entity, will get its own Employer Identification Number, file its own
tax returns and make its own tax elections. 75 FR 55699 (9/14/10); REG – 119921-09, RIN
1545-B169. The same is true for a foreign cell, if the cell would be an insurance company for
tax purposes. These regulations have not been finalized.

There is a grandfather rule for entities created before September 14, 2010, which generally
requires that “nothing” has changed.