CAPTIVE INSURANCE COMPANIES ASSOCIATION®

www.CICAworld.com

June 9, 2023

Uploaded to Federal Rulemaking Portal
https://www.regulations.gov
Re: IRS and REG-109309-22

Internal Revenue Service
CC:PA:LPD:PR (REG-109309-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Attn: REG-109309-22

To Whom It May Concern:

The Captive Insurance Companies Association provides comments to the "micro-captive" regulations [REG-109309-22] proposed by the Treasury on April 11, 2023, addressing captive insurance companies that make an election as provided by section 831(b) of the Internal Revenue Code (the "Code")[1].

I. BACKGROUND ON CICA

The Captive Insurance Companies Association (CICA) is the leading domicile-neutral trade association representing the captive insurance industry. CICA represents over 460 members and CICA's members are individual captive insurance companies, companies that own and utilize captives, and service providers to captives, such as actuaries, accountants, attorneys, and insurance consultants. A majority of our members are based in the United States and are important contributors to the US economy. Captive insurance is an important mechanism for companies to provide more efficient risk management financing decisions for businesses, public entities, and not-for-profit organizations. CICA is a 51-year-old section 501(c)(6) not-for-profit entity that also serves as an umbrella organization to the individual state and country domicile associations.

In addition to serving as an umbrella organization for captive insurance associations, CICA convenes thought leaders on captive insurance topics and comments

[1] Unless otherwise indicated, section references are to the Internal Revenue Code, as currently in effect. References to the proposed regulations include the commentary associated with the actual proposed revisions to the Treasury Regulations 88 F.R. 21547 (No. 69 4/11/23) and the preceding press release IR-2023-74 (4/10/23). Unless otherwise stated, defined terms in these comments have the same meaning as they do in the proposed regulations.

on captive insurance issues where appropriate. CICA also serves as a liaison among and resource for the domiciles, regulators, insurance companies, service providers, and associations in the captive insurance industry.

CICA stands ready to be a resource to the IRS as to these proposed regulations, in the same way that it is to its members and the various participants in the captive insurance industry.

II. ALTERNATIVE RISK TRANSFER AND INSURANCE

The commercial insurance market has historically met the general insurance needs of a wide variety of insureds, particularly the needs of individuals. But there are inefficiencies, gaps, and exclusions in meeting the needs of businesses. Because of this, the "alternative risk transfer" area has arisen to address these needs. The captive insurance industry is a critical component of the alternative risk transfer segment. Captives fill in the gaps and exclusions in the commercial market, supply coverage where the commercial market chooses not to provide coverage, and serves as the laboratory for identifying and managing emerging risks, in some cases before the commercial market responds. For instance, while the commercial market almost uniformly denied coverage for COVID-related claims, captive insurance companies had written broader coverages that did not have the same limitations as commercial insurance policies; this resulted in many COVID claims being covered by captives. Beyond filling coverage gaps, captives also allow companies to provide traditional property and casualty lines coverage likes workers' compensation and liability coverage where doing so provides benefits to the Captive owner that are not available in the commercial market. There are powerful business and economic reasons for captives to exist.

CICA supports a vibrant captive insurance industry. CICA believes that bona fide captive insurance companies, both large and small, are critical to overall risk management, and therefore, the economy.

III. THE IRS MUST TARGET ONLY <u>ABUSIVE</u> TRANSACTIONS

We are aware the IRS has won three cases involving insurance companies electing section 831(b)[2] and one that asserted tax exemption under section 501(c)(15)[3]. We are also aware that the IRS has a long-time campaign against **<u>abusive</u>** arrangements involving insurance companies that elect to be taxed under section 831(b). The proposed regulations confirm that the IRS view of these transactions has not changed.

---

[2] *Avrahami v Commissioner*, 149 T.C. 144 (2017); *Syzygy Insurance Co., Inc. v. Commissioner*, T.C. Memo 2019-34; and *Caylor Land & Development, Inc. v. Commissioner*, T.C. Memo 2021-30.

[3] *Reserve Mechanical Corp. v. Commissioner*, 34 F. 4th 881 (10th Cir. 2022), *aff'g* T.C. Memo 2018-86.

We assume, and acknowledge, that the IRS will continue its search for abusive arrangements, and CICA supports the efforts by the IRS to eliminate truly abusive captive insurance arrangements. CICA has been an unwavering proponent of having captives formed for risk management purposes and for operating them utilizing industry best practices.

We note, then, that the IRS is not seeking to invalidate non-abusive transactions. Consistent with case law, Notice 2016-66 states that the Treasury and IRS recognize that taxpayers can insure with insurance companies that elect section 831(b), if they are not used abusively[4]. The "Dirty Dozen" and similar notices expressly target only "abusive" transactions. We are also aware that the IRS has publicly conceded a Tax Court case involving Puglisi Egg Farm, indicating that the IRS will not challenge non-abusive transactions. Consistent with this, the proposed regulations ask for suggestions to distinguish between abusive and non-abusive transactions. Abusive transactions are listed transactions, each of which the IRS believes is a tax avoidance transaction, whose purported tax benefits the IRS will challenge. The IRS must thus draft listed transaction regulations that describe abusive listed transactions **only**, and not sweep up any other transactions into the listed transaction category.

Moreover, the final regulations should make it clear that (1) the purpose of naming the described "micro-captive" transactions as either listed transactions, transactions of interest, or both, is to obtain disclosure, and (2) that the factors of $1 of premium in a finance transaction, or a 65% loss ratio, have no bearing on the ultimate determination as to whether the transaction is insurance for Federal income tax purposes, or if the captive is an insurance company for Federal income tax purposes.

This is the long-standing approach described by the House Ways and Means Committee in discussing the American Jobs Creation Act of 2004, which was enacted to supplement the regulatory framework for listed and other reportable transactions. The amendment imposed penalties for late filing of disclosure forms. The Committee made it clear that disclosure was the goal of the amendments, and not determining the validity of the underlying transaction for tax purposes. H. Rept. 108-548, at 260-261.

IV. PROPOSED REGULATIONS AND THEIR SUGGESTED CRITERIA FOR IDENTIFYING ABUSIVE TRANSACTIONS

The proposed regulations define "Captive" as an insurance company that elects to be taxed under section 831(b), and which has at least one owner of at least 20% of the equity, who is an Insured, an Owner of an Insured, or related thereto. In these comments, we use the term "Captive" in the way that it is used in the proposed regulations.

[4] Section 1.04

If a Captive provides at least $1 of premium for the financial benefit of the Insured or affiliate (called the Recipient) and the Recipient does not report income (*e.g.*, as in a Captive loan to the Insured, which is not taxable income to the Insured), the proposed regulations categorize this as a "listed transaction." Transactions by a Captive with a loss ratio over the most recent ten years of less than 65% are also labeled as a listed transaction. If the Captive has been in existence less than 10 years, then the transaction will be a transaction of interest if the loss ratio for the Captive's existence is less than 65%.

Listed transactions are transactions that are **always** tax avoidance transactions and will always be challenged by the IRS. In the eyes of the IRS, these are the worst transactions; Congress requires that these transactions be disclosed by the participant (Form 8886), and by the material advisor (Form 8918). Penalties and an extension of the statute of limitations arise under certain circumstances. A transaction of interest is also reportable on Forms 8886 and 8918, but the circumstances or amount under which it will have penalties may be less than for a listed transaction.

CICA believes that it is imperative that the IRS not label transactions as listed transactions that are properly characterized as transactions of interest, and that the IRS not label transactions as transactions of interest when they in fact do not have the potential for tax avoidance. As written, the proposed regulations do not accomplish this task, as discussed in the next section.

V. BRIGHT-LINE TESTS TO DEFINE INSURANCE OR IDENTIFY "ABUSIVE" LOSS RATIOS ARE INHERENTLY UNWORKABLE

The proposed regulations and their suggested tests for identifying abusive transactions will not succeed in identifying abusive versus non-abusive transactions for a number of reasons, but chief among them are (1) the lack of a precise definition for "insurance" in a tax or insurance context, and (2) loss ratio is an improper test to identify a listed transaction.[5]

---

[5] Note, as well, that making a section 831(b) election, or any other election provided by the Internal Revenue Code, can never be *per se* abusive. Congress has identified two (or more) ways to tax a transaction, and permitted the taxpayer to choose which way it prefers to be taxed. Such decisions will likely be made based on the choice that will produce less tax. But that is perfectly acceptable, because Congress provided that choice.

The IRS seems to view the section 831(b) election as a tax windfall, but it is not always advantageous. It is sometimes said that no tax is paid on the premium income, but that is not correct. The typical situation is that a small captive insurance company is closely held, and the insureds are pass-through entities, so only a single level of tax is paid. By paying the premium to the insurance company, tax is deferred; it is not escaped. The operating income of the insured is reduced and transferred without tax to the captive. The captive gets no tax deduction for the payment of insurance losses or other expenses associated with adjusting the losses, or for operating the insurance program. Any net underwriting income is subject to a single level tax when it is distributed; under today's law, this income would be typically taxed at the qualified dividend (or long-term capital gain) rate. Accordingly, if there is net insurance income, it is still taxed on a single level when the election is made, although that tax is deferred and

A. Drafting Immutable Parameters for Listed Transactions is Extremely Difficult Because Neither the Courts or the Insurance Professionals Have Precisely Defined Insurance

The reason why it is hard to devise precisely tailored tests to identify abusive insurance transactions is that there is no "definition" of insurance. It is not defined in the Internal Revenue Code or the Treasury Regulations. It has thus been left to case law. The Courts have generally looked to a United States Supreme Court opinion, *Helvering v. Le Gierse*,[6] where the Supreme Court held that to determine what is "insurance" in a tax context, one must look to what is "'insurance' in its commonly accepted sense." 312 U.S. at 540. Thus, there is no "special" definition of insurance specifically for "tax": It is what is commonly accepted. More recently, in a captive context, the Tax Court said, "A special rule for tax purposes is not justified by either statute or case law." *Sears & Roebuck*, 96 T.C. at 101-102. The early income tax cases involving captive insurance companies cited *Le Gierse*, until the Tax Court took a comprehensive look at the definition of insurance in three companion cases. These cases make it crystal clear that there is no definition of insurance, but rather only a **"framework"**[7] to analyze the question. **The courts are clear that the test is inherently one of "facts and circumstances" – not a bright line test.**[8]

---

typically at a lower tax rate, but tax is not escaped. Moreover, the investment income is subjected to two levels of tax (both at the entity and shareholder level), whereas it would typically be taxed at only one level if there were no captive insurance arrangement. Thus, the election is a detriment if there are insurance losses, and typically a benefit if there is insurance income, but at the cost of double taxation of the investment income; this is the trade-off that Congress devised (not always good, not always bad), and allowed the taxpayer to pick the route it thinks will be best. Finally, the captive must pay for administrative expenses of owning and operating a captive, and this cuts into, and sometimes eliminates any financial benefit that might accrue due to deferring taxes to a lower tax rate, but the ample risk management benefits of operating a captive insurance company remain.

[6] 312 U.S. 531 (1941)

[7] *Amerco v Commissioner,* 96 T.C. at 38 (emphasis and capitalization added) ("These four principles **do NOT yield a definition of insurance**. They do, however, create what we believe is a proper **framework** to be adopted when addressing a question of the existence of insurance for Federal tax purposes. They are not independent or exclusive. Instead, we read them as informing each other and, to the extent not fully consistent, confining each other's potential excess."

[8] In *Harper Group and Subsidiaries v. Commissioner*, the Tax Court held, "In our opinion, the tax treatment of an alleged insurance payment by a parent or affiliated company to a captive insurance company is to be governed by (1) the facts and circumstances of the particular case, and (2) principles of Federal taxation, rather than economic and risk management theories."96 T.C. at 57. [The principles of Federal taxation is separate taxpayers under the Moline Properties case; see footnote 9 of Harper Group]. *See also Sears*, 96 at 100 (emphasis added) (*"Our approach here is to state a **formulation or framework** and apply it to the facts of this case. "); Rent-A-Center, Inc. v. Commissioner,* 142 T.C. 1 at 13-14 (emphasis added) (These four criteria are not independent or exclusive, but establish a **framework** for determining "the existence of insurance for Federal tax purposes." Insurance premiums may be deductible. A taxpayer may not, however, deduct amounts set aside in its own possession to compensate for perils, which are generally the subject of insurance. We consider all of the **facts and circumstances** to determine whther an arrangement qualifies as insurance."); *Securitas Holdings, Inc. v. Commissioner, T.C. Memo 2014-225*

Even the cases involving section 831(b) that ultimately held that a particular transaction was not insurance for tax purposes used the long-standing "**framework**" for analyzing "facts and circumstances." Judge Holmes, who wrote two of the three Tax Court opinions finding for the IRS in cases involving captives that elected section 831(b) was the most forthright, by calling the line between deductible and non-deductible self-insurance: **"blurry"** in the most recent Tax Court case of *Caylor Land & Development, Inc. v Commissione*r, TC Memo 2021-30 at 32 (emphasis added):

> The line between nondeductible self-insurance and deductible insurance is **blurry**, and we try to clarify it by looking at four nonexclusive but rarely supplemented criteria: [risk-shifting; risk-distribution; insurance risk; and whether an arrangement looks like commonly accepted notions of insurance].

And, the Tenth Circuit in *Reserve Mechanical Corp. v. Commissioner*, 34 F.4th 881, 903-904 (10th Cir. 2022) noted the inexactness of what is insurance is inherent in the insurance world's view of insurance – there is no single concept; and with no single concept in the insurance world, the Court confessed it could not anticipate every nuance in trying to define insurance for tax purposes.[9]

Taking these examples as a whole demonstrates that there is no clear unequivocal definition of insurance, and that it would be very difficult to identify criterion(a) for a listed transaction (a transaction that under all circumstances is a tax avoidance transaction and will be challenged) while not simultaneously capturing transactions that are not under all circumstances tax avoidance transactions).

The reality is, if an observer has seen one captive, they have seen one captive: every situation is completely different, and there thus it would be extremely difficult to etch a single bright-line test for listed transaction abuse. If it is possible, the criteria in the proposed regulations are not the correct standards.

Similarly, there is no "one size fits all" definition of insurance, and it would be folly to try to construct one. Insurance touches every conceivable aspect of life and business. As described below, the determination is done by testing the facts within a framework of factors, which is inherently a "facts and circumstances" exercise.

(emphasis added) ("Although these criteria are not independent or exclusive, they establish a **framework** for determining whether insurance exists under the Federal tax law".)

[9] "But no part of the Code defines the term insurance. Unfortunately, this is not because the definition is obvious. Indeed, the meaning can depend on the context. *See* Robert E. Keeton & Alan I. Widiss, Insurance Law: A Guide to Fundamental Principles, Legal Doctrines and Commercial Practices § 1.1 at 5 (1988) ("There is no single conception of insurance that is universally applicable for use in disputes involving questions of law")… We cannot anticipate every nuance that may arise and provide a comprehensive explication of what is required for a purported insurer…."

B. Less than 65% Loss Ratio is Not a Proper Listed Transaction Parameter

The proposed regulations provide that transactions with a Captive with a loss ratio less than 65% for 10 years is a listed transaction; if the Captive has been in existence less than 10 years, transactions with a Captive with a loss ratio of less than 65% is a transaction of interest. This test is wholly inappropriate.

What's wrong with the less than 65% loss ratio test? In a nutshell, it's a one-size-fits-all approach. The underlying premise appears to be that a small captive insurance company that writes property and casualty insurance must look something like an "average" non-captive insurance company. The reality is that every commercial insurance company has its own risk profile, loss ratios, expenses, and profit and contingencies levels; and none of them are "average."

Again, a listed transaction is one the IRS believes is **always** a tax avoidance transaction and which will **always** be challenged. Thus, parameters that capture transactions that are not **always** tax avoidance transactions are too broad. Notably, the case law has found transactions with less than a 65% loss ratio to constitute insurance. For example, in *R.V.I. Guaranty v. Commissioner*[10], the Court found that the residual value insurance policies issued by R.V.I. were insurance for tax purposes. R.V.I's loss ratios were between 27.7% and 34%. The Court's opinion listed the loss ratio for each year from 2000 through 2013; they spanned from 0.3% to 97.9% [five years had loss ratios less than 1.5%; six years were between 11.5% and 33.2%; the remaining three years were 64.2%, 48.6% and 97.9%]. Thus, the loss ratio fluctuated dramatically, and 13 of the 14 years were below 65%; the median was between 18.1% and 20.4%.

The fact that R.V.I. had low loss ratios and the arrangement was nonetheless insurance for tax purposes demonstrates that there is nothing abusive per se with a long-term loss ratio less than 65%. It cannot be a listed transaction, because it is proof that not **all** transactions with a loss ratio less than 65% are tax avoidance transactions. In this case, the Tax Court found the arrangement to be insurance for tax purposes. There are other issues with loss ratios as a test, including that they are a function of fortuity and loss prevention and captives often insure against low-frequency, high-severity risks; they are backward-looking (and as such, a taxpayer would not know they were involved in a listed transaction until it was too late – beyond the year being tested for listed transaction status); and it is impossible to predict or manage claims to a single, arbitrary point.[11]

[10] *R.V.I. Guaranty Co. Ltd. v. Commissioner*, 145 T.C. 209 (2015).

[11] The proposed regulations provide that a captive could repay premium as a policy holder dividend to increase the loss ratio. The policy holder dividend has its own concerns. It is backward facing (not being able to be computed until after year has ended that may be a year with a reportable transaction). A simple example illustrates an additional issue. Suppose Insured will pay a newly created captive $1,000,000 premium in each of two years. Suppose the insured has two $650,000 losses during the first two years. If one of the losses occurs in Year 1 and the other in Year 2, then the IRS is satisfied. If there were no losses in year 1, and $1,350,00 of losses in Year 2, then the

C. Comments on the Proposed Regulation Approach to Loss Ratio

CICA takes the position that no such industrywide standards exist. Treasury can try to compare "micro-captives", or any other captives, for that matter, to Property & Casualty industrywide data (for non-captives), and Treasury will almost always be comparing apples and oranges.

The proposed regulations point to NAIC data as support for its 65%. The proposed regulations admit that it is an average across all coverages (consumer and business, all locations, all industries, etc.), across all insurance companies, and without regard to whether captives electing section 831(b) do, or are even authorized to, write the coverages going into the averages. This "one size fits all" does not work when viewing the small captive industry as a whole, and certainly does not work when looking at the "facts and circumstances" of a single captive.

There are several examples of entire lines of coverage that have a lower than 65% loss ratio over the last decade. Just one example is Boiler and Machinery coverage. Using the same NAIC data the Treasury used, it shows that the loss ratio[12] was 43.5% over the last ten years (i.e, 2012 to 2021, the same ten years used by Treasury to support their selection of the 65% value). Companies that sell Boiler and Machinery coverage are not abusive tax avoidance transactions, despite their long-term loss ratio being well below 65%. 2,069 insurance companies[13] filed NAIC reports over the last ten years; when common ownership is considered, there were 1,059 groups of insurance companies. Of these 882 companies (42.6%) and 548 groups (51.7%) had ten-year loss ratios less than 65%. These commercial insurance companies did not engage in abusive tax avoidance (listed) transactions – and no one can even assert that roughly half the commercial insurance transactions are listed transactions. Other data arises from the back-up to the NAIC data. Fully eight groups with over a billion dollars of ten-year premium had a loss ratio of under 45% over that period:

proposed regulations would declare the year 1 transaction a listed transaction. The "solution" would be for the captive to declare a policy holder dividend of the entire first year premium of $1,000,000 (the only way to avoid a less than 65% loss ratio for Year 1). Thus, captive must pay is expenses from capital. In Year 2, Captive will incur $1,300,000 of losses, but will only have $1,000,000 (the second year premium) to pay them with (and any net investment income and capital.) That does not address any regulatory issues, and policy provisions.

[12] Loss ratio is losses plus loss adjustment expenses over the ten years, divided by earned premium over the ten years.

[13] With net earned premium greater than $0 for years 2012-2021

TABLE 1: INSURANCE GROUPS WITH OVER $1B IN PREMIUM AND LESS THAN 45% LOSS RATIO

	10 YEAR		
Group Name	**EARNED PREMIUM**	**LOSS & LAE**	**LOSS & LAE RATIO**
NMI Holdings Grp	1,545,173,748	97,973,945	6.3%
Essent Grp	3,700,110,371	329,960,568	8.9%
Assured Guar Grp	3,228,703,526	603,334,406	18.7%
Radian Grp	8,470,667,144	2,805,732,484	33.1%
Genworth Fin Grp	7,060,947,753	2,490,441,617	35.3%
OneMain Holdings Inc Grp	1,314,164,315	504,312,212	38.4%
Jewelers Mut Grp	1,889,883,685	828,880,075	43.9%
AMEX Assurance Co.	1,731,580,173	765,915,223	44.2%

Moreover, over that ten-year period, 56 insurance companies, and 32 groups, had a zero or lower loss ratio; the negative loss ratios are unexpected, but result from refunds, reversal of transactions, etc. The fact that there can be so many insurance companies and groups that have zero or below loss ratios over such a long period of time, underscores why loss ratio is an incorrect measure.

The examples in this paragraph are representative of others and demonstrate the fallacy of assuming that a single average industry average for all commercial insurance companies can ever be the standard.

D. Treasury's Own Terrorism (TRIA) Program Has a Zero % Loss Ratio

In late 2002, Congress passed the Terrorism Risk Insurance Act of 2002 ("TRIA") to provide reinsurance to insurers writing terrorism coverage. Insurers effectively stopped providing this coverage after the 9/11 attacks, but with a backstop from the Federal Government, insurers re-entered this market in 2003. TRIA (and succeeding renewals of TRIA through 2027) is administered by Treasury. Insurers collect premiums for terrorism insurance from policyholders and keep these premiums (i.e, nothing is remitted to Treasury). If there is a "certified act of terrorism" – where Treasury certifies that the act met certain thresholds, then Treasury would reimburse insurers at a specified percentage (currently 80%) after certain deductibles have been met. Below is an excerpt from the February 10, 2022, Congressional Research Service "IN FOCUS" publication.

> Analyses by Treasury have seen TRIA as supporting a terrorism insurance market that is generally stable with available and affordable insurance. Estimates for the *take-up rate* for terrorism coverage range from around 60% to nearly 80% depending on what metrics are used. The total premiums for all TRIA-eligible lines of insurance was $214 billion in 2019, with an estimated 1.7%, or $3.7 billion, attributable to terrorism risk premiums. (This figure includes affiliated insurers known as captives.) Between 30% and 35% of the terrorism coverage is provided as part of broader insurance without a specific charge. In total,

> Treasury estimates that insurers have received $51.9 billion in terrorism insurance premiums from 2003 through 2019.

Elsewhere in the document, it asserts the following:

> No attack has been certified under the act and no federal payments have been made.

Accordingly, there has been $51.9 billion in TRIA premium from 2003 to 2019, and zero losses – resulting in a 0% loss ratio from 2003 to 2019.

To be fair, there have been terrorism losses in the insurance industry, but none that have met the "certified" threshold. So, the actual effective loss ratio on that $51.9 billion of premium is likely greater than zero. But notionally, some of that premium covered potential risks that met the "certified" definition after the corresponding deductibles. Whatever percentage of that $51.9 billion of premium is allocable to the TRIA layer/band of coverage, it's still a 0% loss ratio. The result is that Treasury itself oversees an insurance mechanism that to date, on billions of dollars of premiums, has had no losses at all over approximately 20 years. And surely these premiums are not considered as Transactions of Interest or Listed Transactions.

E. The True Measure is How Premiums are Derived, and Not Loss Ratio

Insurance is the management and financing of risk. The insurance company assumes risk, and the IRS is right to want to make sure that the premium received is reasonable. But using loss ratio as the measuring stick for whether a transaction is abusive is the wrong instrument. The inherent problem is that **losses are evidence of risk, but lack of losses is not evidence of lack of risk**. If my house burns down, but my neighbor's house does not, I have substantial losses, but my risk was no different than my neighbor's. Naming a transaction as a listed transaction is a very serious matter; it has to be done correctly. Using loss ratio is the wrong measure, the correct measure is whether the method of computing premiums was proper.

This brings us to the crux of the matter – insurance pricing, which is the sum of expected losses, expected expenses, profit margins, and risk loads (called contingency loads or contingency margins in the actuarial literature). While Treasury chose to look at broad industry-wide data and information, the individual pieces that make up the totals and averages are where the answers lie.

For coverages that make up the lion's share of premiums (including auto, homeowners, workers compensation), the coverages are generally priced with single digit profit and contingencies (combined) margins. For these coverages, the actual loss ratios, across the industry, don't deviate too much from the expected levels.

But, with highly specialized and rarely triggered coverages, where historical claims data and information is not readily available, insurers often rely on both actual and simulated loss experience to assess these unusual risks. In addition, it is common to include contingency margins to compensate the insurers for taking these risks and for maintaining extra capital to support these exposures. Using property catastrophe coverage as an example (generally for weather related events and earthquakes), depending on the layer of coverage provided, risk loads or reinsurance expenses as a percentage of premium can be over 50%, and expected loss ratios can be as low as 10%.

For these types of coverages, actual loss ratios are not consistent year over year, and over a long period of time, would likely be far less than 65%. Captives electing section 831(b) often provide highly specialized coverages that command high contingency margins. These captives can go years without claims (like the coverage afforded by Treasury/TRIA, with 0% loss ratios), or loss ratios less than 65% (like Boiler & Machinery). This can be across a broad spectrum of companies over a long period of time. This is not because there is some malice or failure, but because of the types of risk, frequency of loss, and fortuity.

The true test is alluded to in the proposed regulations. It is not loss ratio, but rather the method of determining premiums. The only "job" of an insurance company is to pay claims as and when they come due. This is accomplished by having appropriate premiums. The goal is to:

> employ actuarial techniques to establish premium rates that appropriately reflect the risk of loss and costs of conducting an insurance business[14]
>
> *****
>
> The primary purpose of premium pricing is to ensure the funds are available should a claim arise. The pricing of premiums should naturally reflect the economic reality of insurance operations.[15]

These are the touchstones that should be used in evaluating transactions.

The proposed regulations assert that using loss ratio as a trigger captures not only premiums that are priced too high, but also artificially low or nonexistent claims activity. But, the reality is that premiums that are actuarially determined and that follow all of the actuarial standards of practice for ratemaking can and do produce loss ratios that vary significantly. Where historical claims data is plentiful (high frequency), losses, and hence, loss ratios, can be predicted with reasonable accuracy. When the opposite is true (low

[14] 88 F.R. 21555

[15] 88 F.R. 21557

frequency), loss ratios cannot be predicted with reasonable accuracy. And standards for ratemaking call for higher premiums relative to predicted losses to compensate insurers for taking on such uncertain risks – resulting in lower loss ratios.

Based on the above, CICA believes that no such industrywide “magic bullet” exists for a one-size fits all loss ratio (which is even further compounded by the fact that a loss ratio cannot be established until after the expiration of the year for which a listed transaction or transition of interest are being tested.)

V. CONCLUSIONS AND RECOMMENDATIONS

For the reasons laid out above, and based on its industry experience and the interests of its members, as well as recognizing the IRS’ court victories, the IRS’ conclusion that there is the potential for tax avoidance and that it will continue to audit these transactions, CICA offers the following overall conclusions as to the overall effectiveness of the proposed regulations and recommendations for ensuring the proposed regulations target only abusive transactions.

Conclusions

1. Courts have consistently held that what constitutes “insurance” for tax and other purposes is inherently a facts-and-circumstances test, judged against a “framework” and not a definition.

2. The Tax Court has found insurance to exist in transactions that would have been labeled listed transactions under the proposed regulations, so the proposed regulations are overbroad and run afoul of the case law.

3. Being labeled a listed transaction is very severe; transactions should only be designated as listed transactions if the parameters **only** capture transactions that are tax avoidance transactions, and **none** that have the potential to be tax avoidance transactions (transactions of interest).

4. If the listed transaction parameters ensnare transactions that are properly labeled as either transactions of interest or not labeled at all, then the parameters should be used to designate the transactions as transactions of interest (or not designated at all), and not listed transactions.

5. It would be very difficult to precisely identify transactions that are **always** tax avoidance and always to be challenged (listed transactions), without ensnaring other transactions, and certainly the proposed parameters do not accomplish that.

Recommendations[16]

1. The proposed regulations make it clear that the Treasury believes that there are abusive transactions, and that the Treasury will finalize these regulations by designating certain transactions as reportable transactions. Based on this premise:

    a. The finalized regulations should not identify any transactions as listed transactions based on the current parameters, or any parameters that would ensnare transactions that are not unequivocally **always** tax avoidance transactions.

        i. The final regulations should not use the parameters in the proposed regulations to designate any transactions as listed transactions.

        ii. Unless the Treasury and IRS can unequivocally articulate transactions that do not ensnare (A) transactions properly labeled as transactions of interest or (B) transactions that have no potential for tax avoidance, the final regulations should not contain any listed transactions; given the nature of insurance, and the established case law and principles, it will be very difficult to meet this standard.

    b. The final regulations should identify as transactions of interest:

        i. Transactions where the method of computing premiums lies outside "actuarial techniques that appropriately reflect the risk of loss and cost of conducting an insurance business"[17], unless they are aligned with established market rates for comparable coverages.

    c. Loss ratio should not be used as a factor for any reportable transaction.

2. The Treasury and IRS should make it clear that the purpose of labeling certain transactions as either listed transactions or transactions of interest is so that they will be disclosed to the IRS. They should also be clear that the factors used have no bearing on whether a transaction is insurance for tax purposes

[16] These comments do not address the "financing" element of the proposed regulations. We let others address that element, but conclusions apply equally to that element.

[17] 88 F.R. 21555. The Casualty Actuarial Society has adopted nine Actuarial Standards of Practice for premium pricing (numbers 1, 12, 23, 25, 29, 30, 41, 53 and 56). Actuaries must also follow the Code of Conduct of the American Academy of Actuaries. These would be the standards to assure that the actuarial techniques were appropriate.

or the captive is an insurance company for tax purposes. There is no "one size fits all" definition of insurance; every evaluation is based on the "facts and circumstances" involved.

3. The Treasury and IRS should permit captives who have elected to be taxed under section 831(b) a window within which a revocation of the election will be automatically approved, under reasonable parameters concerning the documentation that must be provided and the consequences of the revocation.

CICA looks forward to the IRS substantively addressing its comments and questions, and to working together to ensure only abusive transactions are the target of IRS enforcement activity.

Sincerely,

Dan Towle

Daniel Towle, CICA President