

June 2005 Captive Federal Income Tax Update

Another holding of Rev. Rul. 2005-40 addresses an issue that was uncertain prior to this ruling. A single-member LLC is disregarded as an entity separate from its owner for most federal income tax purposes unless it makes an election to be treated as a corporation. A single parent entity (a corporation, partnership or LLC) can create multiple subsidiary LLCs that are recognized as separate legal entities for liability purposes but are treated as non-existent for federal income tax purposes. In Rev. Rul. 2005-40, the IRS held that disregarded single-member LLCs are *not* treated as separate insureds for purposes of determining whether an insurer has distributed its risk among a sufficient number of insureds. Under Rev. Rul. 2005-40, a parent corporation could own 100 disregarded single-member LLCs and create a captive to insure all of those LLCs, but if the captive had no other insureds, there would be insufficient risk distribution to meet the federal tax definition of “insurance.”

Concurrently with Rev. Rul. 2005-40, the IRS issued Notice 2005-49, which requests comments concerning the standards that should apply to determine whether an arrangement constitutes insurance for federal income tax purposes. The notice states that the IRS is aware that guidance is needed in this area, but does not indicate when such guidance will be forthcoming. In addition to requesting comments on issues that should be addressed by future IRS guidance, the notice requests comments regarding

- (1) the factors to be taken into account in determining whether a cell captive arrangement constitutes insurance and, if so, the mechanics of any applicable federal tax elections;
- (2) circumstances under which the qualification of an arrangement between related parties as insurance may be affected by a loan back of amounts paid as “premiums;”
- (3) the relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance, and
- (4) federal income tax issues raised by transactions involving finite risk.

Future guidance issued by the IRS regarding those issues or any issues related to the definition of “insurance” under federal income tax law could have a substantial impact on the federal income tax treatment of a wide variety of captive insurance arrangements. The public comment period announced in Notice 2005-49 expires October 3, 2005.