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Analysis that matters from Washington National Tax

Survey of 2021 Insurance Tax Developments

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This survey provides brief summaries of developments within the last year that affect insurance companies and their products, includes commentary on selected items, and provides links to *TaxNewsFlash* articles and certain source materials. Developments are organized under the following headings: General Insurance Guidance, Health Insurance Guidance, and State Tax Issues.

1. General Insurance Guidance

1.1 Tax Court Holds Microcaptive Insurance Company Arrangement Fails: *Caylor Land & Development, Inc. v. Commissioner*

The IRS has long viewed microcaptive insurance transactions as potentially abusive tax transactions. Microcaptives first appeared on the IRS "Dirty Dozen" list of tax schemes in 2014 and were made transactions of interest via Notice 2016-66. Captives that make an election under section 831(b) [1] are taxed on their investment income and not on their underwriting income or losses.

The Tax Court in Caylor focused on two criteria—risk distribution and insurance in the commonly accepted sense. The Tax Court concluded that the taxpayer had failed to meet either requirement. The captive, Caylor, did not respond to policyholder claims consistent with typical industry norms. Caylor also did not calculate premiums consistently with industry practices nor were the premiums

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

substantially actuarially determined. The IRS disallowed the 831(b) transaction and assessed interest and penalties in accordance with section 6662(a).

KPMG Observation

The IRS will continue to disallow tax benefits from transactions determined to be abusive. The IRS may also require domestic captives to include premium payments in income and assert a withholding liability related to foreign captives.

In 2020, the IRS offered a settlement initiative for taxpayers who participated in abusive microcaptive insurance transactions. In general, terms of accepting the settlement include liquidating the captive or recognizing a deemed qualified dividend that is designed to simulate the tax consequences of the captive shareholders distributing all assets from the captive. Applicable, but reduced, penalties may be applied under section 6662(a).

Captive insurance companies should consider consulting with an advisor to determine whether the insurance company materially meets the common notions of insurance.

Read the *TaxNewsFlash* for more information.

1.2 *CIC Services, LLC v. Internal Revenue Service*

CIC Services, LLC v. Internal Revenue Service is a long running and ongoing court case that challenges Notice 2016-66.

Notice 2016-66 states that microcaptive transactions have the potential for tax avoidance or evasion and are transactions of interest. Taxpayers engaged in these transactions must disclose the transactions. A failure to disclose will be subject to the penalty under section 6707A or section 6707(a). Treasury and the IRS recognized in Notice 2016-66 that related parties may use captive insurance companies that make elections under section 831(b) for risk-management purposes not involving tax avoidance. During 2020, the IRS sent approximately 150,000 letters to captive insurance companies that made an 831(b) election, urging those taxpayers to review and exit any abusive captive arrangements.

CIC Services, a captive services manager, has been in litigation with the IRS on its approach to microcaptive insurance companies and Notice 2016-66. CIC Services filed a lawsuit in 2016 concerning the notice's implementation and sought an injunction from the federal district court to prohibit its enforcement. CIC services argued that when developing the notice, the IRS violated the notice-and-comment rulemaking procedure, consistent with the Administrative Procedure Act. The government argued that the suit against it was enjoined by the Anti Injunction Act. The U.S. Supreme Court heard the case and held that the Anti Injunction Act was not applicable. Thus, the case was remanded back to the lower courts to determine if Notice 2016-66 complied with the Administrative Procedures Act. No further decisions have been reached to date.

KPMG Observation

Since Notice 20166-66 has not been invalidated yet, we recommend that entities involved in microcaptive transactions continue to comply with the notice.

Read the *TaxNewsFlash* for more information.

1.3 IRS Issues Two Favorable BEAT PLRs for Insurance Company

On March 5, 2021, the IRS released two private letter rulings ("PLRs")—PLR 202109001 and PLR 202109005—that involve the section 59A base erosion and anti-abuse tax ("BEAT") imposed on certain large corporate taxpayers with respect to certain payments made to foreign related parties. First, in PLR 202109001, the IRS determined that an insurance company did not make base erosion payments under section 59A. Second, in PLR 202109005, the IRS determined that an insurance company's contract with a retrocessionaire is reinsurance for federal tax purposes.

In PLR 202109001, the parent of the consolidated group owns 100 percent of the stock of the taxpayer, a U.S.-based insurance company and Corporation A, a domestic corporation. The parent, taxpayer, and Corporation A are indirect subsidiaries of a foreign corporation. The taxpayer entered into agreements with two foreign insurance companies to transfer insurance risk. The PLR concludes that the agreements did not affect the BEAT liability. Therefore, the taxpayer will not be treated as making a base erosion payment under section 59A(d)(3). In this PLR, the IRS determined that the agreements do not affect the taxpayer's liability under section 59A and, therefore, the taxpayer is not considered to have made a BEAT payment.

PLR 202109005 was issued to a reinsurance company that qualified under section 816 as a non-life insurance company. The taxpayer met the definition of insurance for federal tax purposes, meaning that it included insurance risk, risk shifting, and risk distribution, among other things. The taxpayer made a section 953(d) election, which generally means it is treated as a domestic corporation and computes its U.S. federal income tax as such.

Taxpayer is a subsidiary of parent and is included in parent's consolidated federal income tax return. Parent is a subsidiary of a foreign company, a retrocessionaire that is a regulated insurance company and has not elected under section 953(d) to be treated as a domestic corporation.

The taxpayer entered into a contract with the retrocessionaire with regard to the obligations assumed by taxpayer under specified "Modco" agreements. The IRS determined that the contract between the taxpayer and retrocessionaire would be considered reinsurance because by entering into the contract the retrocessionaire assumed a portion of the risk from the taxpayer.

KPMG Observation

In PLR 202109005, the contract between the taxpayer and the retrocessionaire is reinsurance because, by entering into the contract, retrocessionaire is assuming a portion of the risk from the taxpayer. The taxpayer minimizes its current premium payments through excess of loss contracts for mortality, longevity, lapse, etc., and then, in future years, is only obligated to make payments on a net basis.

The taxpayer's details were redacted from the PLR. PLRs are generally made public after all information has been removed that could identify the taxpayer to which it was issued. PLRs generally cannot be cited as precedent except for the exact situation and taxpayer to which the PLR was issued in the first place. A PLR applies tax laws to the taxpayer's specific set of facts.

1.4 IRS Issues PLR for Annuity Contract Fees

The payment of a life insurance company's advisory fees in an annuity contract will not be treated as amounts received, according PLR 202104001. The IRS ruled that fees deducted by a life insurance company from the cash value of a deferred annuity contract and remitted to an investment adviser will not be treated as an amount received by the owner of the contract for purposes of section 72(e).

KPMG Observation

The IRS determined that the fees were an expense of the adviser contract, so deducting the fees from the contract's cash value and remitting them to the adviser would not need to be treated as amounts received under section 72(e). The fees the taxpayer deducted from the investment adviser contract's cash value and remits to the adviser will not be treated as an "amount received" by the owner of the adviser contract for purposes of section 72(e).

2. Health Insurance Guidance

2.1 Supreme Court Review of *California v. Texas* Case

On June 17, six U.S. Supreme Court justices joined an opinion penned by Justice Stephen Breyer concluding that *California v. Texas*, a Fifth Circuit Court of Appeals case that challenges the constitutionality of the Patient Protection and Affordable Care Act of 2010 ("ACA"), should be dismissed. Justice Thomas concurred; Justices Alito and Gorsuch dissented.

By way of background, in December 2019, the U.S. Court of Appeals for the Fifth Circuit affirmed the trial court's decision that ACA's individual mandate is no longer valid after the Tax Cuts and Jobs Act of 2017 set the penalty amount in section 5000A to zero beginning in 2019. However, instead of deciding whether the individual mandate is severable from the remainder of the ACA or if that law must be struck in its entirety, the court remanded the decision to the lower court for further consideration. The Supreme Court granted certiorari on this question, and oral arguments were held last November.

The majority opinion held that neither the individuals nor the state plaintiffs had "standing" to challenge the mandate or the remainder of the ACA. Specifically, the Court held that with the removal of the tax penalty for noncompliance under section 5000A, the individual mandate was unenforceable against the plaintiffs. Since the mandate already could not be enforced, an opinion stating that the law was invalid would be an advisory opinion. The Court also found that Texas and the other Republican states that were party to the suit lacked standing to challenge the law. The state plaintiffs claimed they were indirectly injured by the mandate because it would cause more people to enroll in Medicaid or state employee programs, an argument rejected by the Court in part due to lack of evidence that increased enrollment was traceable to the unenforceable mandate. Texas also claimed that it would bear higher costs due to ACA reporting and administrative requirements, but the Court found that these costs were not caused by the mandate and would remain even if it were struck.

KPMG Observation

Had the outcome been different, this case could have had far-reaching implications on how health insurance is provided (e.g., coverage of pre-existing conditions), as well as the tax provisions that were included in the ACA affecting health insurers, employers, and other stakeholders (e.g., the excise tax

under section 4980H on applicable large employers who do not provide minimum essential coverage to their employees).

This is the third Supreme Court challenge to the ACA. There are no other ACA challenges pending as of the date of this publication, but the Court in this case did not conclusively preclude any further challenges.

Read this *TaxNewsFlash* for more information.

2.2 American Rescue Plan Act of 2021

The American Rescue Plan Act of 2021 ("Rescue Act"), a $1.9 trillion COVID-19 relief package, was signed into law by President Joe Biden on March 11. The Rescue Act is the second largest economic rescue package in U.S. history, behind only the $2.2 trillion CARES (Coronavirus Aid, Relief, and Economic Security) Act passed in March 2020 at the beginning of the pandemic. The Rescue Act extends unemployment assistance, directs stimulus payments to eligible Americans, expands the child tax credit, and provides funding to support states and local governments and schools in their response to the pandemic.

Notably for the healthcare industry, the Rescue Act represents the biggest healthcare coverage expansion since the Affordable Care Act, enlarging employment-based, individual and small group, and Medicaid coverage. The Rescue Act also provides funding for testing and contact tracing, research and development of vaccines and therapeutics, the public health workforce, and mental and behavioral health services; ensures coverage of COVID-19 vaccines and treatments in Medicaid and CHIP; and eliminates the cap on Medicaid drug rebates.

One significant provision of the legislation allows workers who are eligible for COBRA due to involuntary termination or reduction in hours to receive coverage under their employment-based health plan with a premium reduction of 100 percent. Premium assistance was available to workers beginning the first month following the date of enactment and was available through September 30, 2021. The legislation provided for a payroll tax credit to allow employers and plans to be reimbursed for the full amount of COBRA premiums not paid by workers.

KPMG Observation

The COBRA premium assistance relief enacted as part of the Rescue Act was similar to that enacted in 2009 at the height of the Great Recession. The relief has since expired, and it is unclear that any extension will be enacted.

The Treasury Department and the IRS issued guidance on the premium assistance for COBRA benefits in Notice 2021-31.

Read this issue brief summarizing major healthcare provisions in the Rescue Act, providing a section-by-section summary of all healthcare-related policy changes, and summarizing key non-healthcare provisions.

3. State Tax Issues

3.1 New Jersey Justices Clear Taxpayer of Premium Taxes

Following a previous decision that the taxpayer (a health and wellness corporation) owed $55 million of premium taxes to New Jersey due to premiums paid to a captive insurance company domiciled in Vermont, the taxpayer appealed the New Jersey Tax Court decision to the New Jersey Appellate Division, which reversed the Tax Court's decision and sent the case back to the Tax Court for further proceedings. The New Jersey Supreme Court challenged the state's position that the taxpayer must pay state insurance premium taxes based on risks located throughout the country, suggesting state laws limited the company's charges to risks in New Jersey.

The taxpayer began paying insurance premium taxes on all U.S. premiums it paid to Middlesex Assurance Co. Ltd. for self-procured insurance coverage, but later sought a refund of about $55.9 million in those taxes, plus applicable interest.

The New Jersey Supreme Court determined that the taxpayer is only responsible for state insurance premium taxes based on risks located in the Garden State and not throughout the country. The court signed off on a $55 million tax refund.

KPMG Observation

This decision could lead the way and provide an example for other captive insurance companies and their owners in the state of New Jersey. Entities should review the facts of the case and review their premium tax payments for compliance and reporting purposes.

3.2 Washington State

At the request of the Washington State Department of Revenue and the Office of Insurance Commissioner ("OIC"), on January 18, 2021, Milliman issued its "Captive Insurance Study." The Milliman study evaluated certain policy considerations related to (1) creating an overarching regulatory and taxation framework for captive insurance in Washington and (2) selecting a premium tax base and tax rates relating to premium taxation, and thus formed the framework for subsequent legislation.

In response, Washington enacted a registration and taxation regime for captive insurers. Under the legislation and the subsequent stakeholders draft implementing regulations, eligible captive insurers must register with the OIC. In general, registered eligible captive insurers must pay a two percent premium tax for insurance directly procured by and provided to its parent or affiliate for Washington risks during the preceding calendar year.

In addition, the legislation applies retroactively to periods after 2010. Consequently, if not previously paid to the OIC, premium taxes are due from an eligible captive insurer for any period after January 1, 2011, but are not subject to penalties and fees. As of July 1, 2021, penalties, interest, and fees may be imposed on registered eligible captive insurers.

KPMG Observation

The Washington legislation and regulations impose a premium tax based on the location of the insured risks regardless of whether any insurance transactions take place in Washington. It is difficult to reconcile this approach with the U.S. Supreme Court decision in *State Board of Insurance v. Todd Shipyards Corp.*, 370 U.S. 451 (1962), *affirming* 340 S.W.2d 339 (Tx. Civ. App. 1960). In addition, the legislation imposes the premium tax retroactively to all years after 2010. We can expect foreign captives to argue that they do not have the constitutionally required nexus with Washington to support the imposition of a premium tax and that the imposition of the premium tax to all years after 2010 is unconstitutional.