Captive Insurance Companies

Taxation of a Captive Insurance Company

Is a Captive right for your client?

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Agenda

- What is a Captive?
- Why Consider a Captive?
- Coverage Trends Commercial Markets
- Types of Captives
- Federal Income Taxation
- Choice of Domicile
- Implementation Process

What is a Captive?

An Insurance Company formed by a business owner to insure the risks of related or affiliated businesses.

(Over 50% of the Fortune 1500 have Captives:

Over 90% of S&P Companies)

Why Consider a Captive?

- Improve overall risk management
- Provide coverage for uninsured or hard-to-insure risks
- Earn underwriting profit
- Access to reinsurance market
- Control over claims management
- Potential income tax benefits
- Potential estate planning opportunity

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Trend of Commercial Markets Away From Certain Risks

- Unfair Competition
- Construction Defect
- Wage and Hour
- Mold
- Wind
- Environmental

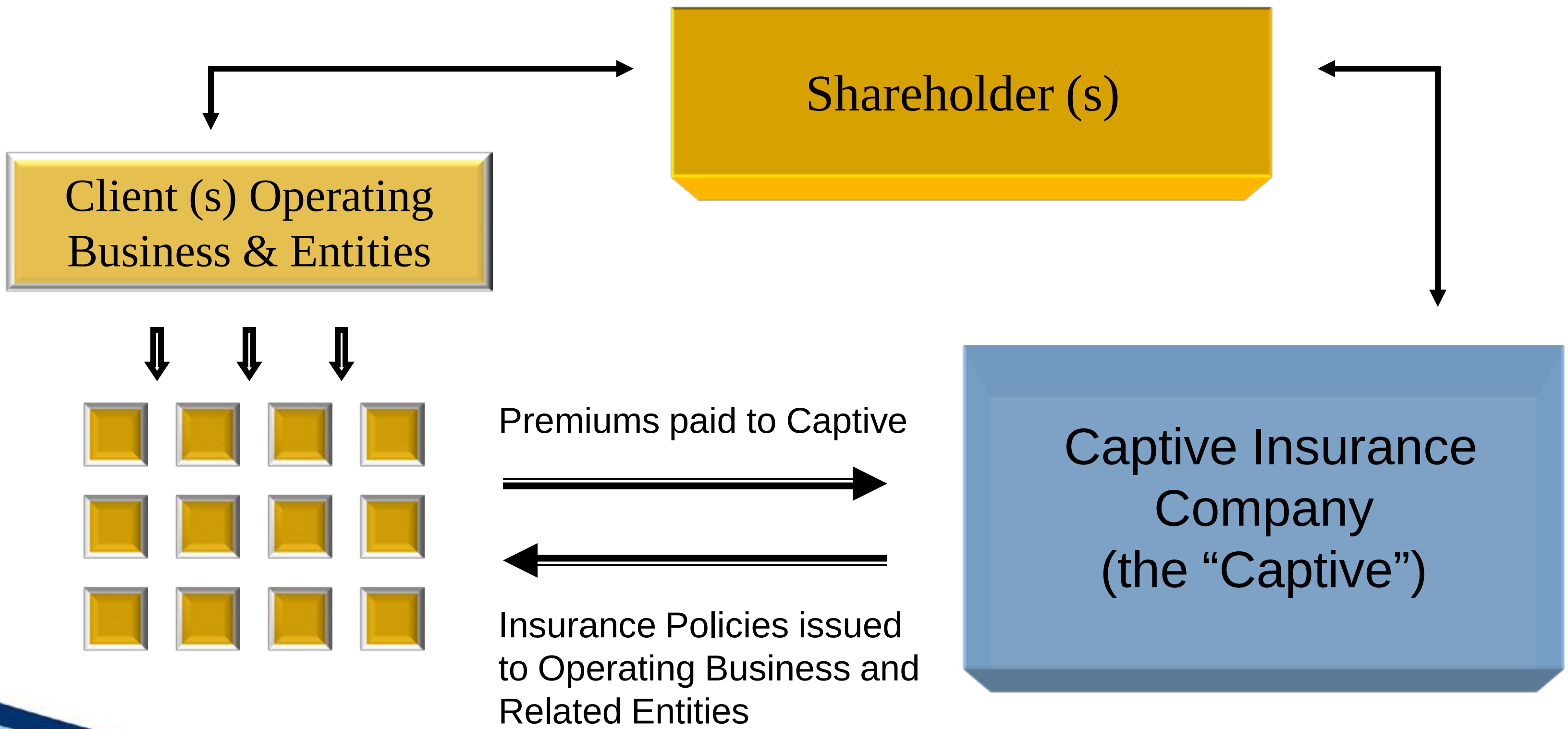
Types of Captives

- Pure Captive
- Group Captive
- Protected Cell or SBU Captive

Every Captive is unique and requires operational and feasibility analysis to determine the optimal structure.

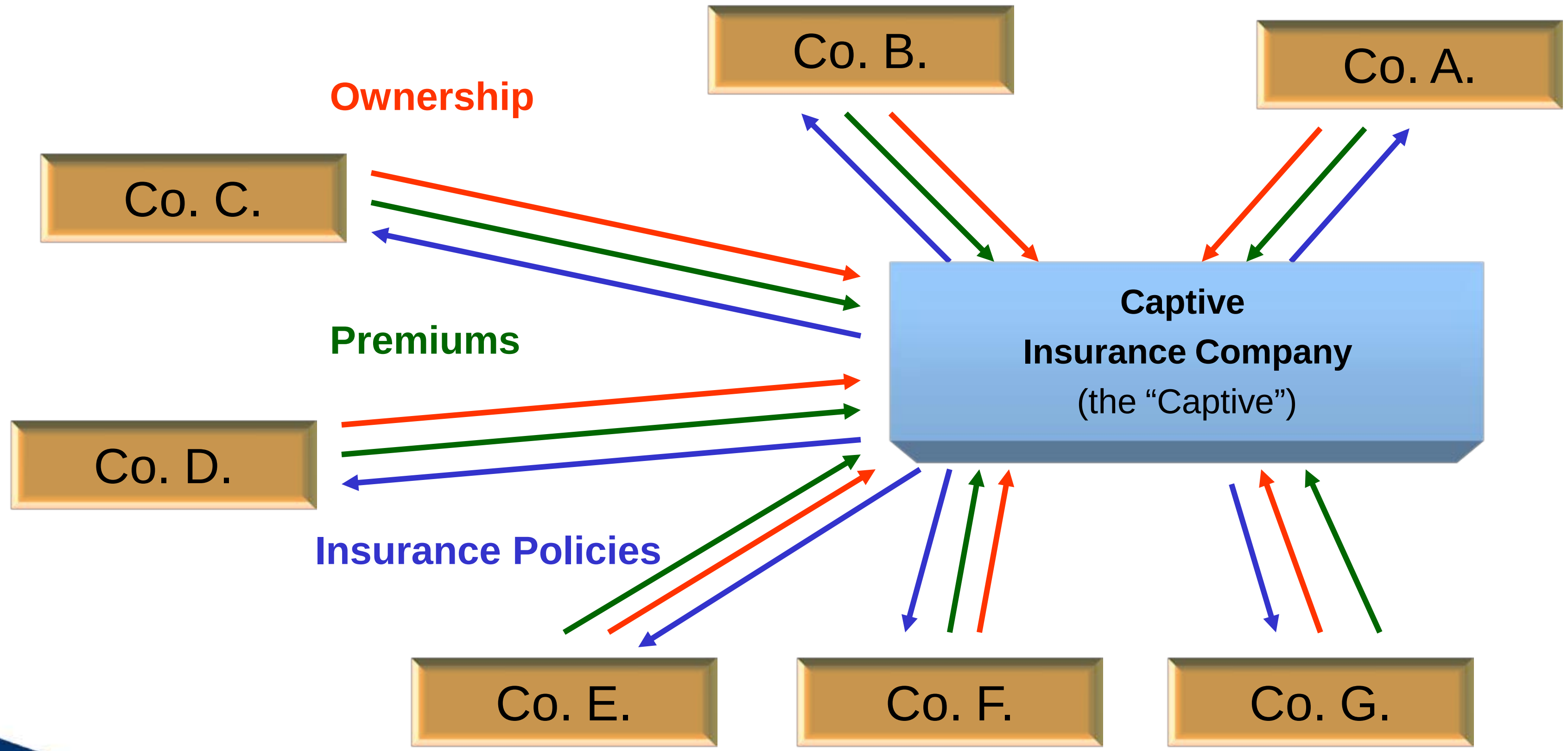
Captive Design – A Pure Captive

A Pure Captive structure primarily insures the risks of the owners operating business and related entities. A pure captive insurance company design may be designed as described below.

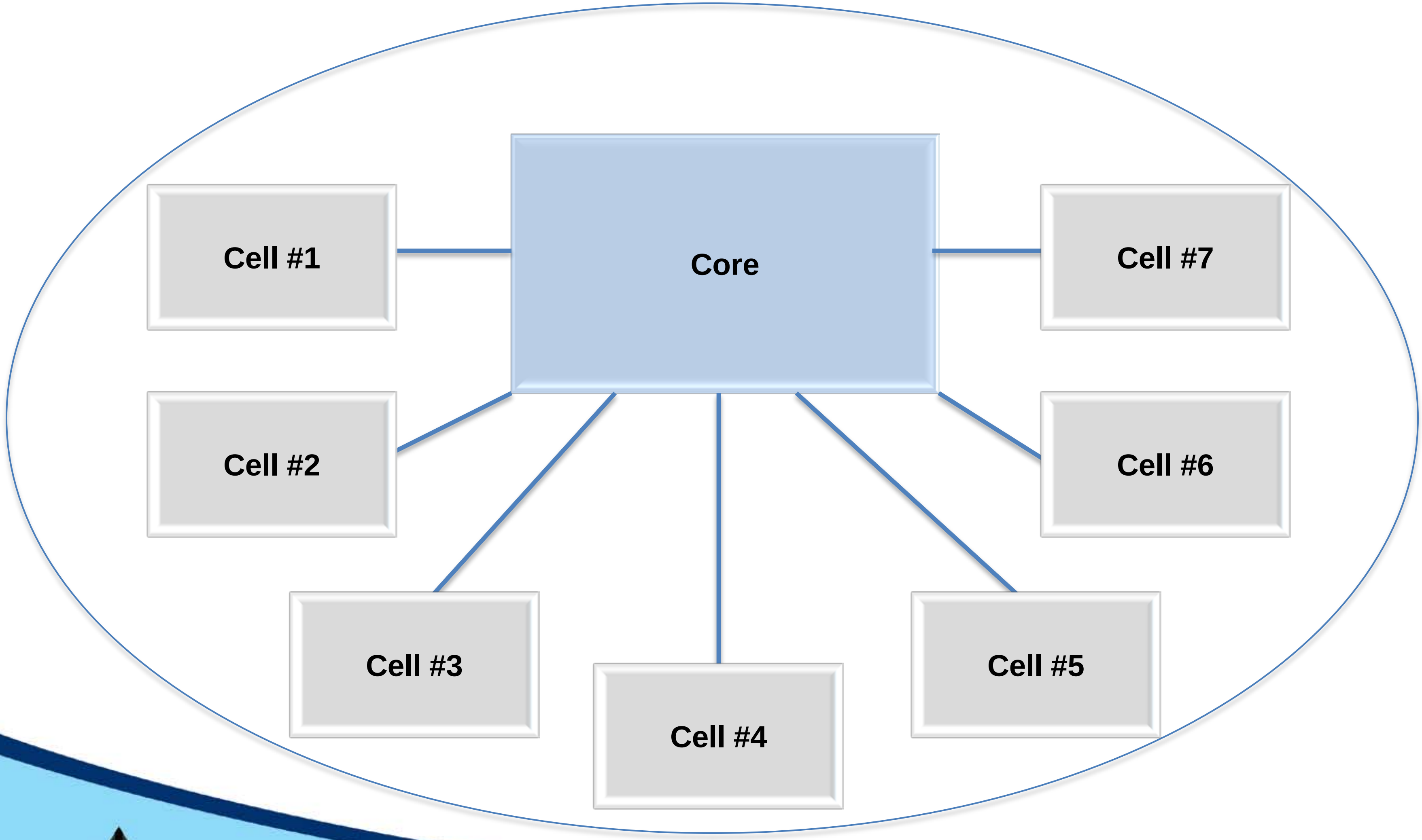


Group Captive Design

A Group Captive is owned by unrelated owners typically similar by industry or size.



Protected Cell Captive Design



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Federal Income Taxation as an Insurance Company

What is insurance? “Commonly accepted notions of insurance”

Helvering v. Le Gierse, 312 U.S. 531 (1941)

Risk Shifting

Risk Distribution

Uninsurable 80-year-old woman purchased a life policy and an annuity policy from the same insurance company one month before death.

Executor did not report death benefit on estate tax return.

Supreme Court found no risk shifted because of offsetting positions; this was just an attempted tax dodge.

First case to set forth the standard for true insurance as required to have both risk shifting and risk distribution.

Business Risk

- CCA 200628018 ruled that an embedded express limited warranty was a business risk and not an insurance risk. The risk was part of the manufacturing process

- It was, to some degree, required by law

- It was part of the purchase price of the item

- It could not be declined by the purchaser in exchange for a refund

- The insured controlled the manufacturing process so the risk lacked the fortuity

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Insurance Risk

- A risk (it may occur)
- Not an eventuality (it may not occur)
- Not an investment risk
- Not a business risk

    - Where do you draw the line?

Tax Advantages of a Captive Insurance Company

Deduction of premiums by Insureds

Generally, the loss reserves are deductible by a captive which shelters Premium Income to the captive


MARCH 24, 1986
$1.95
TIME
STOCK SURGE
How the Boom Machine Works
Sorry, America, Your Insurance Has Been Canceled

Tax Treatment of “Small” Captives

831(b) Captive
If premiums are less than $1.2 Million per year, no tax on premium income

831(b) Election allows Captive with $1.2 million or less premium income to elect to be tax exempt from premium income

Tax is paid on investment income at corporate rates

Federal Income Tax Requirements

- Bona-fide Business Purpose / Risk Management
- Risk Transfer
- Risk Distribution
- Operates as an Insurance Company
- Reasonable Premiums
- Adequate Capitalization
- Common Notions of Insurance

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Federal Income Taxation Risk Shifting

Some History

Revenue Ruling 77-316, 1977-2 C.B. 53

- Service creates the “economic family doctrine”
- Risk must be transferred outside of the economic family to be true insurance
- Key focus was on a lack of risk shifting, therefore not insurance and premiums not deductible

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Federal Income Taxation Risk Shifting

More History

Court Rejection of Economic Family Doctrine

Carnation Company v. Commissioner, 640 F.2d 1010 (9th Cir. 1981) (taxpayer loss – largely on other grounds)

Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (T.C. 1985) (taxpayer loss – largely on other grounds)

Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989) (taxpayer victory – mostly)

Harper Group v. Commissioner, 979 F. 2d 1341 (9th Cir. 1992) (Tax payer victory)

Federal Income Taxation Risk Shifting

The Service won in most cases where the captive insured the parent (still problematic today), but lost in cases where the captive insured affiliates owned by a common parent.

The taxpayer losses were never on the basis of the economic family doctrine, as the courts consistently refused to apply this bright-line test as too overly inclusive and instead applied a facts & circumstances test.

Federal Income Taxation as an Insurance Company

Revenue Ruling 2001-31, 2001-1 C.B. 1348

Service determines it will no longer raise the economic family theory

Explicitly acknowledged that no court had fully adopted the economic family theory set forth in Rev. Rul. 77-316

Analysis is now a case-by-case analysis

Service promised more challenges based on facts and circumstances

Focus is on risk shifting, risk distribution, inadequate capitalization, and parental guarantees

Federal Income Taxation Risk Distribution and Shifting

Case law developed two theories:

<u>Theory 1 (Third Party Theory)</u>

Sufficient third party premium with related premiums
Courts say 30% third-party insurance is adequate

<u>Theory 2 (Balance Sheet or Brother-Sister Theory)</u>

Sufficient related party entities insured to create risk distribution and shifting

Federal Income Taxation Risk Distribution

Third Party Theory

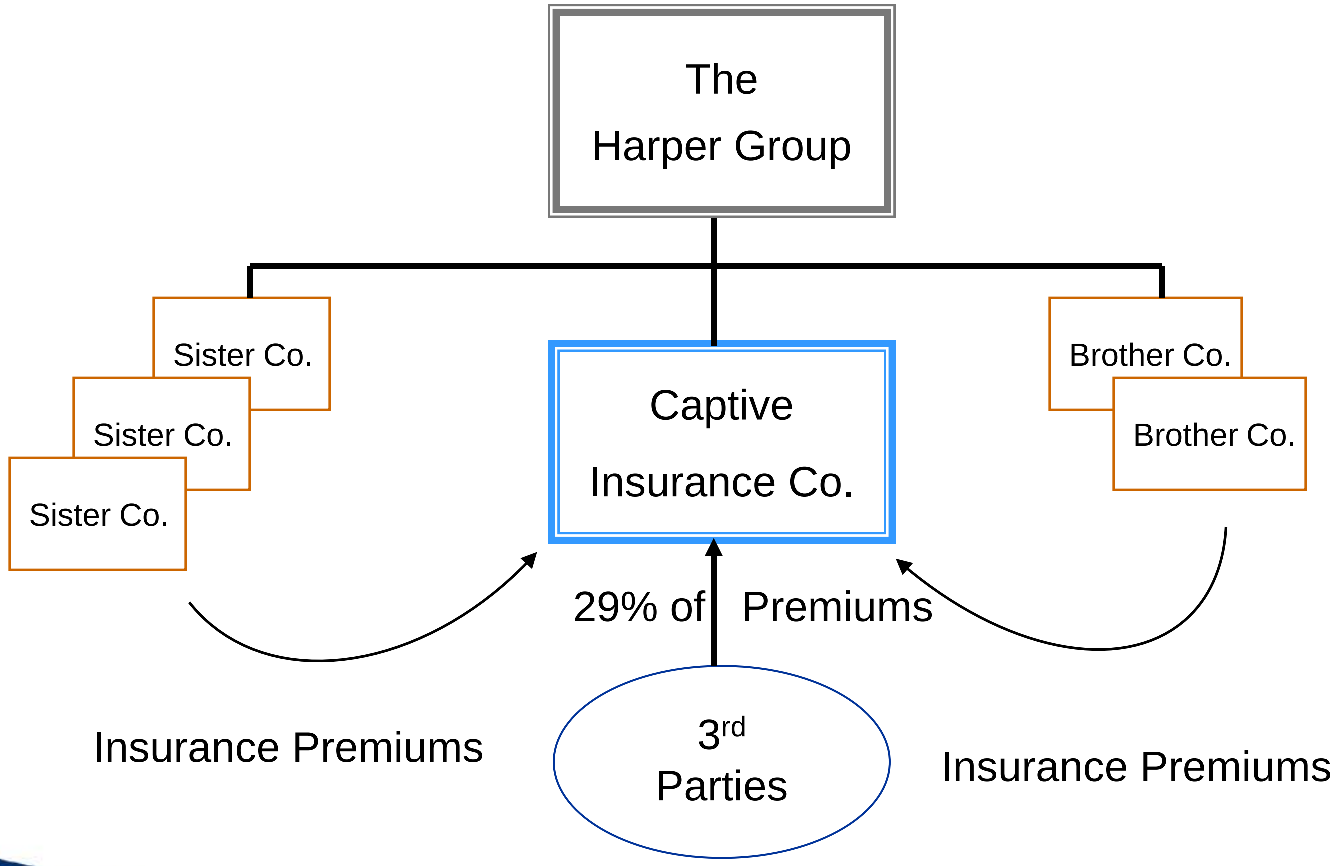
Courts have ruled that, if the captive writes sufficient unrelated premiums, related business is also deductible.

Courts allowed 30% unrelated premiums (Sears, AMERCO, Harper Group, Ocean Drilling 2% insufficient).

Rev. Rul. 92-93 and Rev. Rul. 2014-15 for employees benefits seems to recognize employees benefits as third party insurance.

Third Party Case

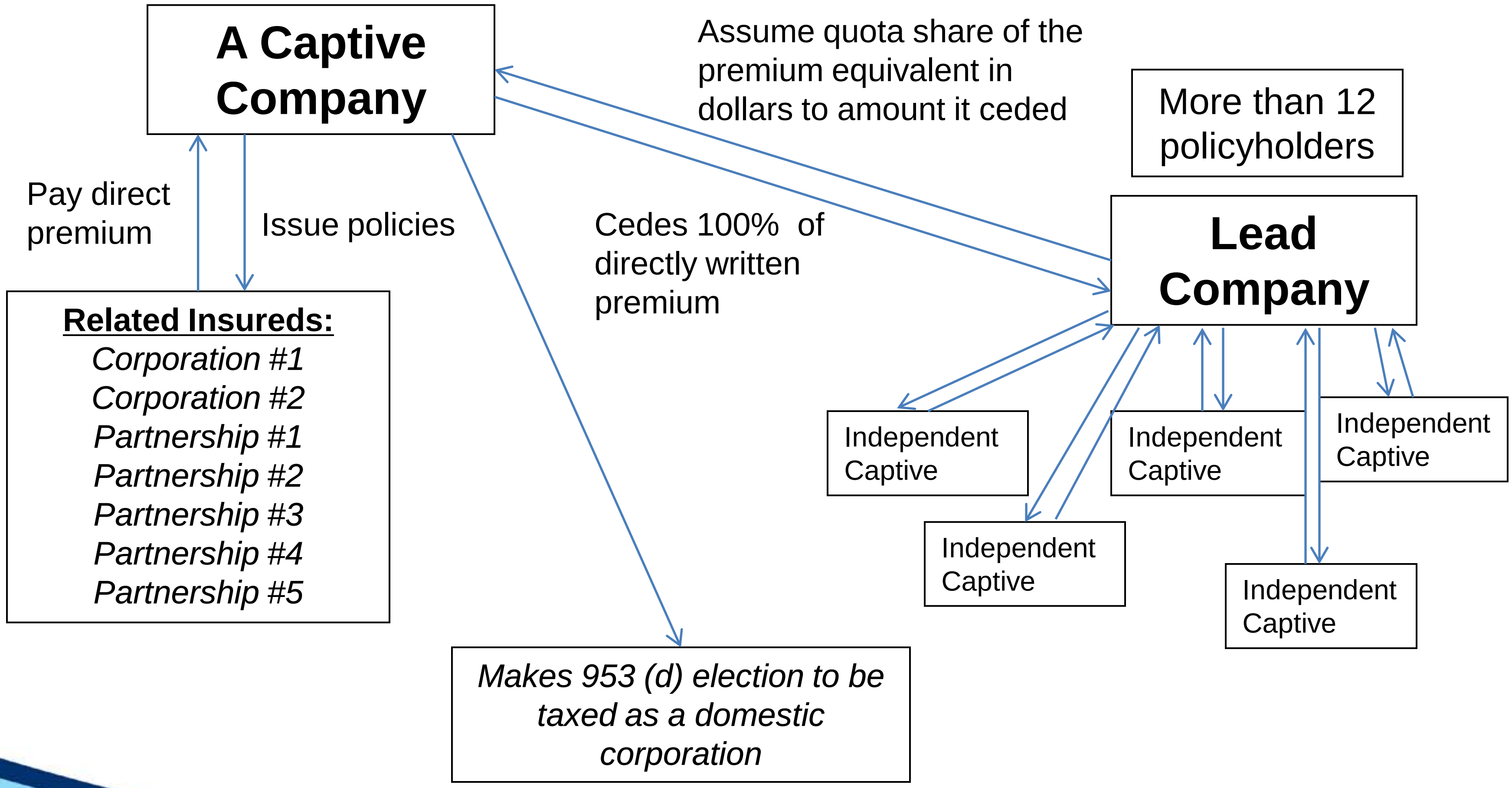
The Harper Group, Inc. v. Commissioner (1992)



What is Third Party Risk?

- Pools
- Service Contracts
- Employee Benefits
- Customer Risks
  - Travel insurance
  - Package insurance

PLR Pool Chart



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Federal Income Taxation Risk Shifting

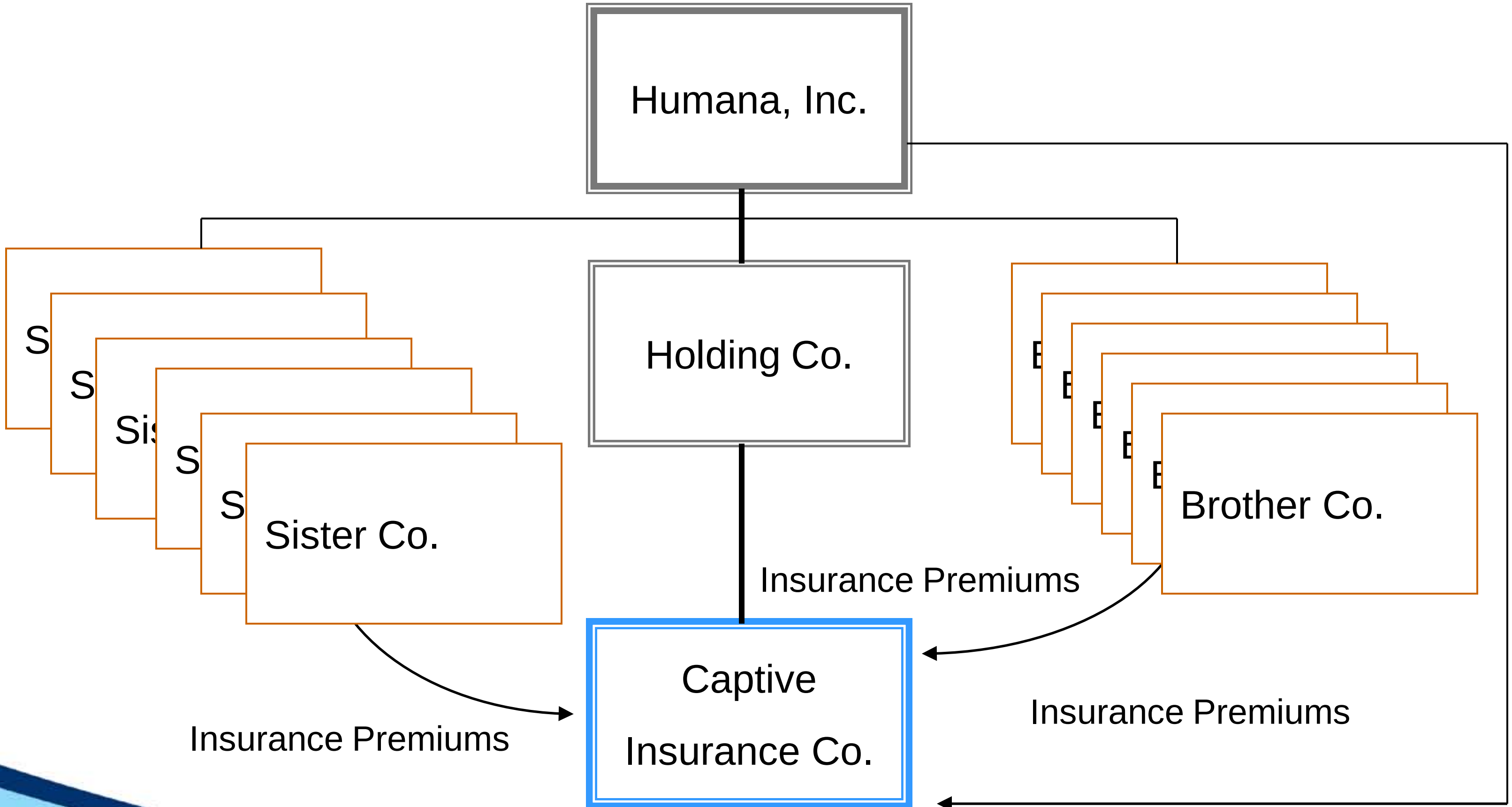
The Balance Sheet / Brother-Sister Theory

Allows deduction of premiums paid to a brother-sister captive without unrelated business.

Originally had favorable decisions only in the Sixth Circuit (Humana, Hospital Corporation of America); subsequently expanded to all taxpayers (Kiddie).

BALANCE SHEET CASE

Humana, Inc. v. Commissioner (1998)



Premiums allocated to Parent would not be deductible

Third Party Revenue Ruling

Rev. Rul. 2002-89 - ruled on deductibility of parent's premiums where captive had 10% unrelated business (unfavorable ruling) and 50% unrelated business (favorable ruling).

- Note Harper's 30% decision is in the middle.
- Gulf Case – 2% third party business was insufficient.
- Unrelated premium percentage was determined on both gross and net; gross should not be relevant.
- Requirement for homogeneous risks does not make sense from an actuarial approach or from case law.
- Captive was licensed in multiple U.S. States; captives are traditionally not licensed in multiple U.S. States.
- The risks were from different States.
- Risk must be spread.

Balance Sheet Revenue Ruling

Rev. Rul. 2002-90 - ruled on premiums paid by sister companies to a captive owned by their parent, with 12 subsidiaries, none with more than 15% or less than 5% of the Total Risk insured on a net and gross basis

Postulates 12 fairly equal-sized subsidiaries.

Note none less than 5% total risk requirement.

Requires that risks be homogeneous.

Requires that risks be from different States.

Requires that captive be licensed in all 12 States

Group Captive Revenue Ruling

Rev. Rul. 2002-91 - ruled on premiums paid by seven separate unrelated companies to a commonly owned captive.

No member owns more than 15%

No member has more than 15% voting power

No member is insured for more than 15% of the total risks

Disregarded Entities Ruling

Treatment of disregarded entities (*i.e.,* LLC's) – Rev. Rul. 2005-40 says they are disregarded, risk of a single member LLC is risk of the parent

Inconsistent with the Balance Sheet theory.

Inconsistent with treatment IRS wants for partnerships.

Single member LLC's are respected by the IRS in other contexts.

Most importantly, disregarded entities are respected for liability and legal purposes, and that is what is being transferred in insurance transactions. They have separate balance sheets

Relationship between Insured and Captive Owner Ruling

Rev.Rul. 2005-40 says that, even if the insurer is adequately capitalized and completely unrelated, if there are an insufficient number of insureds, you may not have risk distribution, and thus no insurance.

<u>If not insurance, what is it?</u>

Insured has paid an adequately capitalized, unrelated entity for goods or services

<u>What is the rationale?</u>

If an insurer insures 10,000 buildings in 500 cities against fire, does the law of large numbers work differently, from the insurer's perspective, if one entity owns them all?

12 or more insured can ensure risk distribution

Related parties that are separate taxpayers are considered separate premium payers

50% third party risk is adequate

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Rent – A – Center Tax Court Case

- Points of Exposure
- Concentration of Risk
- Premium Determination

Other IRS Guidance

TAM 200816029Service will not count limited partnerships with a common general partner as separate entities

- No logic to the Service's argument that the common general partner bears all risk of loss – Property coverages for example

Rev Rul 2008-8 Protected Cell Captives - Service requires risk distribution within each cell, not just within the overall organization, as cells are segregated from each other for liability purposes

Rev. Rul. 2009-26 - To Determine risk distribution regarding a reinsurance contract one must look through to the risks of the ultimate insured – The Primary (underlying) Insurance Contract

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Domicile Choice

- On Shore vs. Off Shore
- Local Taxes
- Federal Taxes
- Capitalization
- Investments of Captive
- Favorable Environment
- Loan Backs

Implementation Process

- Feasibility study prepared by actuary
- Choice of domicile
- Corporate formation
- Underwriting process
- Policies written
- Regulatory application/license received

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