

Hot Topics in Captive Insurance and Risk Pooling Arrangements

Phoenix, AZ
Jan. 24, 2014

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Overview of Captive Insurance Companies

Tax Benefits of Captive Insurance Companies

Captive Owner

- Certain insurance premiums are a deductible business expense. Section 162(a); Treas. Reg. 1.162-1(a).



- Estate and gift tax planning

Tax Benefits of Captive Insurance Companies

Captive

- Deduction for discounted insurance reserves, unearned premiums
- Captives earning less than \$1.2 million in annual premium may elect to pay U.S. taxes on only their investment income. Thus, premium income is not taxed. Section 831(b).
- Section 501(c)(15) captives are exempt from all Federal income tax

Insurance Company

- More than 50% of business is issuing insurance contracts or reinsuring risks underwritten by insurance companies. Section 816(a).
- Insurance Company Classification
 - Life. Section 816(a)
 - Property & Casualty (“P&C”). Section 831(c)
 - Traditional lines: General liability, product liability, workers’ compensation, director and officer (D&O) liability, auto liability, professional liability (e.g., medical malpractice), etc.
 - Specialty lines: Unique or high risk such as industry specific, cyber risk, terrorism, etc.
- Domicile
 - Domestic
 - Foreign
 - Foreign with section 953(d) election

Brief History of Captives

- 1600's: First usage of captives
- 1950's: Fred Reiss develops modern captive concept
- 1962: Bermuda enacts captive legislation
- 1981: Vermont enacts first domestic captive legislation
- 1986: Section 831(b) enacted
- 1996: Delaware enacts Series LLC structure
- 1997: Guernsey enacts cell structure
- 2002: IRS issues 3 seminal Revenue Rulings providing safe-harbors for captive insurers
- 2013: OECD suggests captive insurance may be a vehicle for tax avoidance

Types of Captives

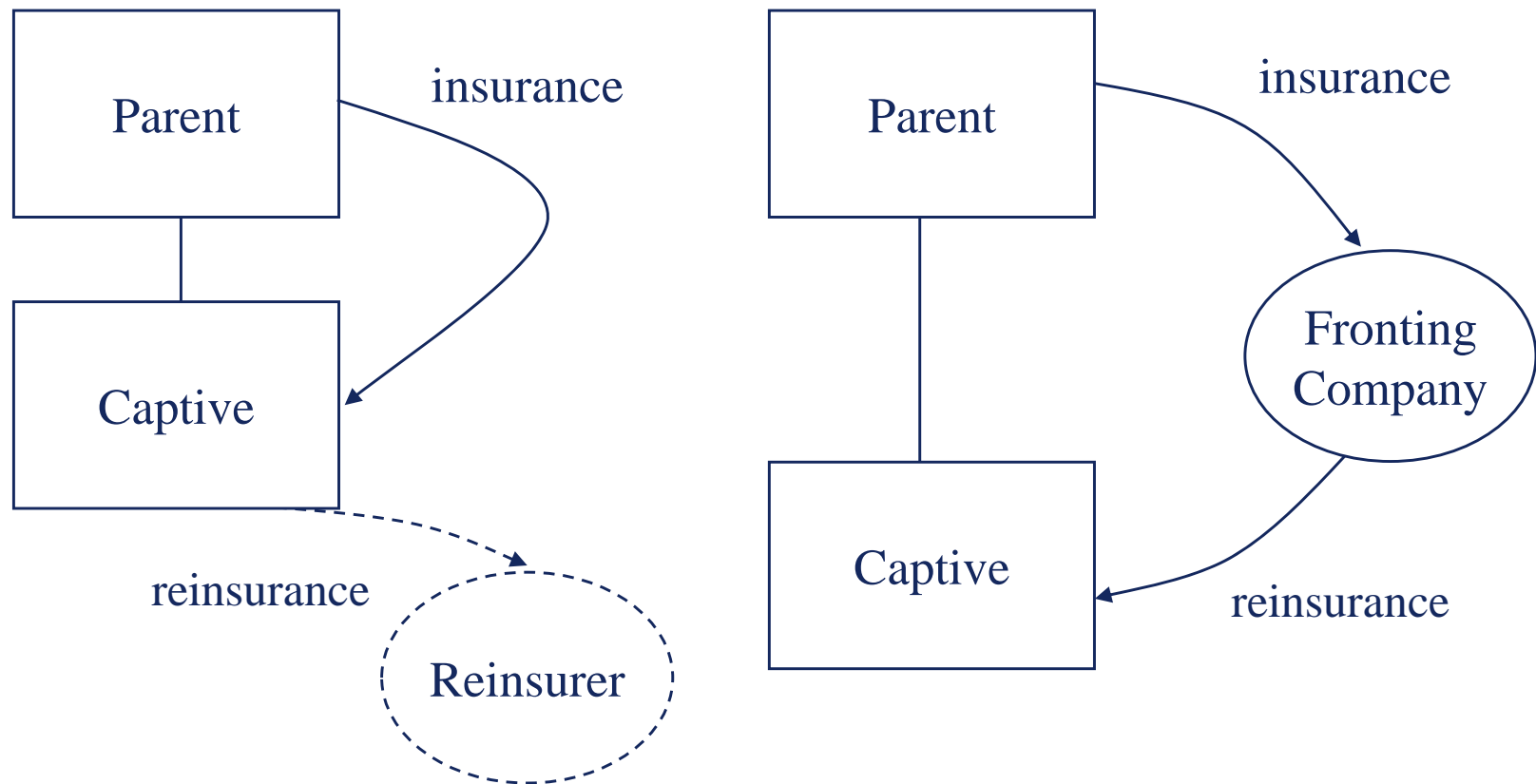
- Single-parent captive (“pure”)
 - Section 831(b) captive (“small” or “micro”)
 - Section 501(c)(15) exempt captive
- Group captive
 - Association captive
 - Industry captive
 - Rent-a-captive
 - Cell captive (“sponsored”)
- Agency captive; producer-owned reinsurance companies (“PORC”)
- Risk retention group (“RRG”)

Typical Captive Owners

- Fortune 500 companies
- Middle market companies
- Closely-held business
- Professionals, esp. medical

Common Captive Structures

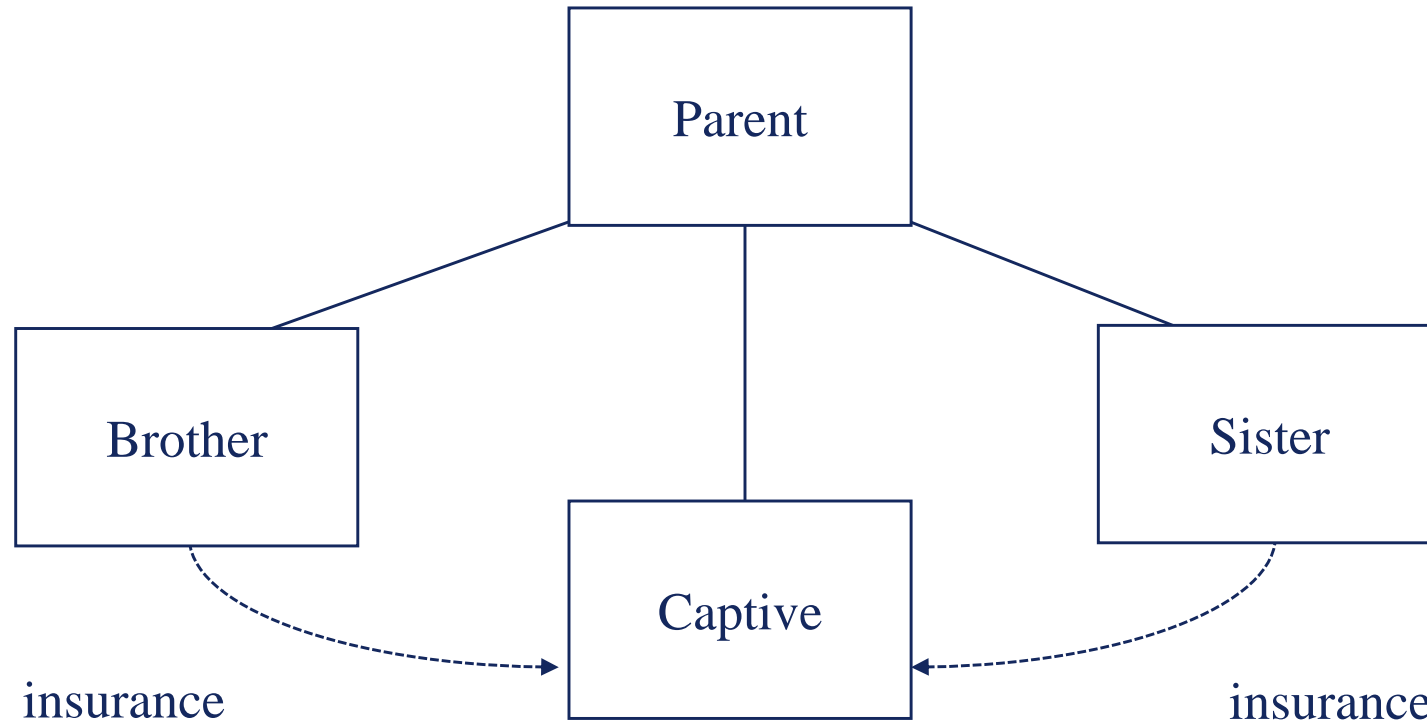
- Parent-Subsidiary



Note, diagram does not depict a valid insurance company arrangement.

Common Captive Structures (cont'd)

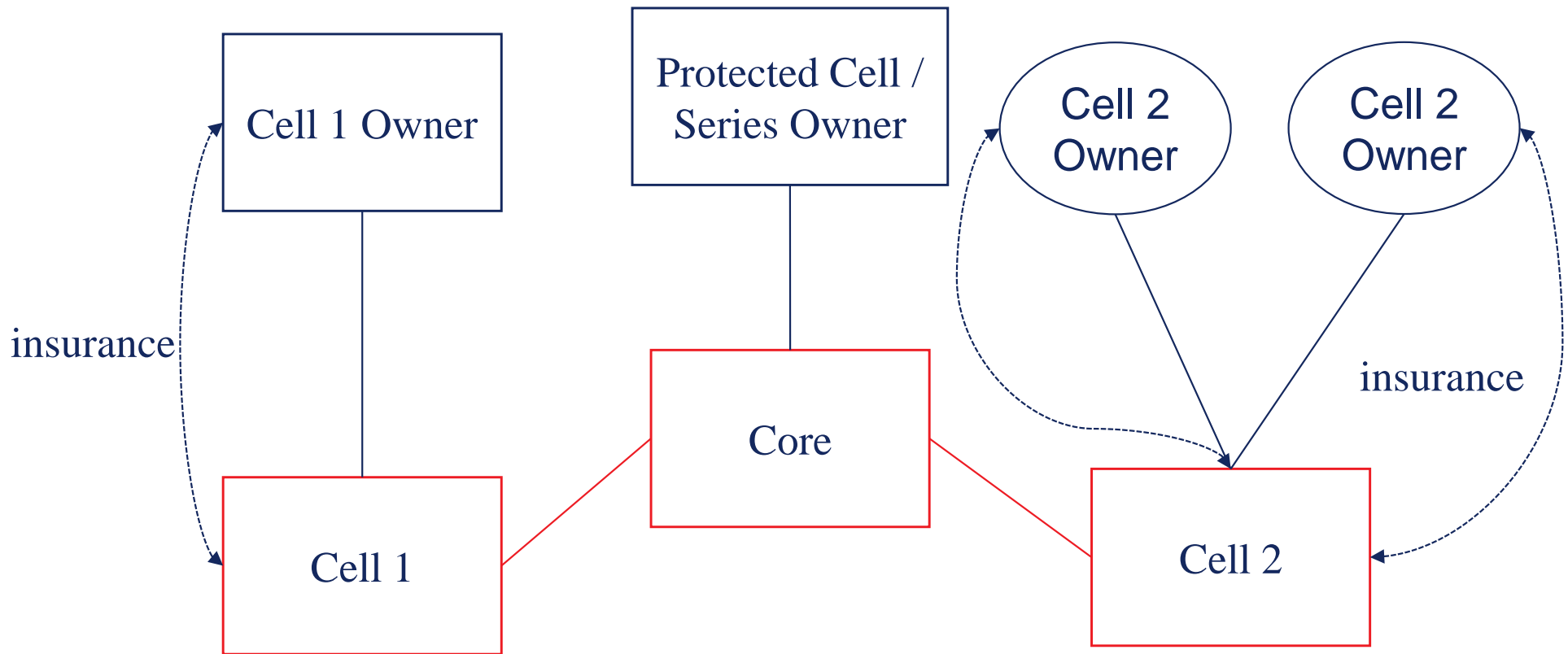
- Brother-Sister



Note, diagram does not depict a valid insurance company arrangement.

Common Captive Structures (cont'd)

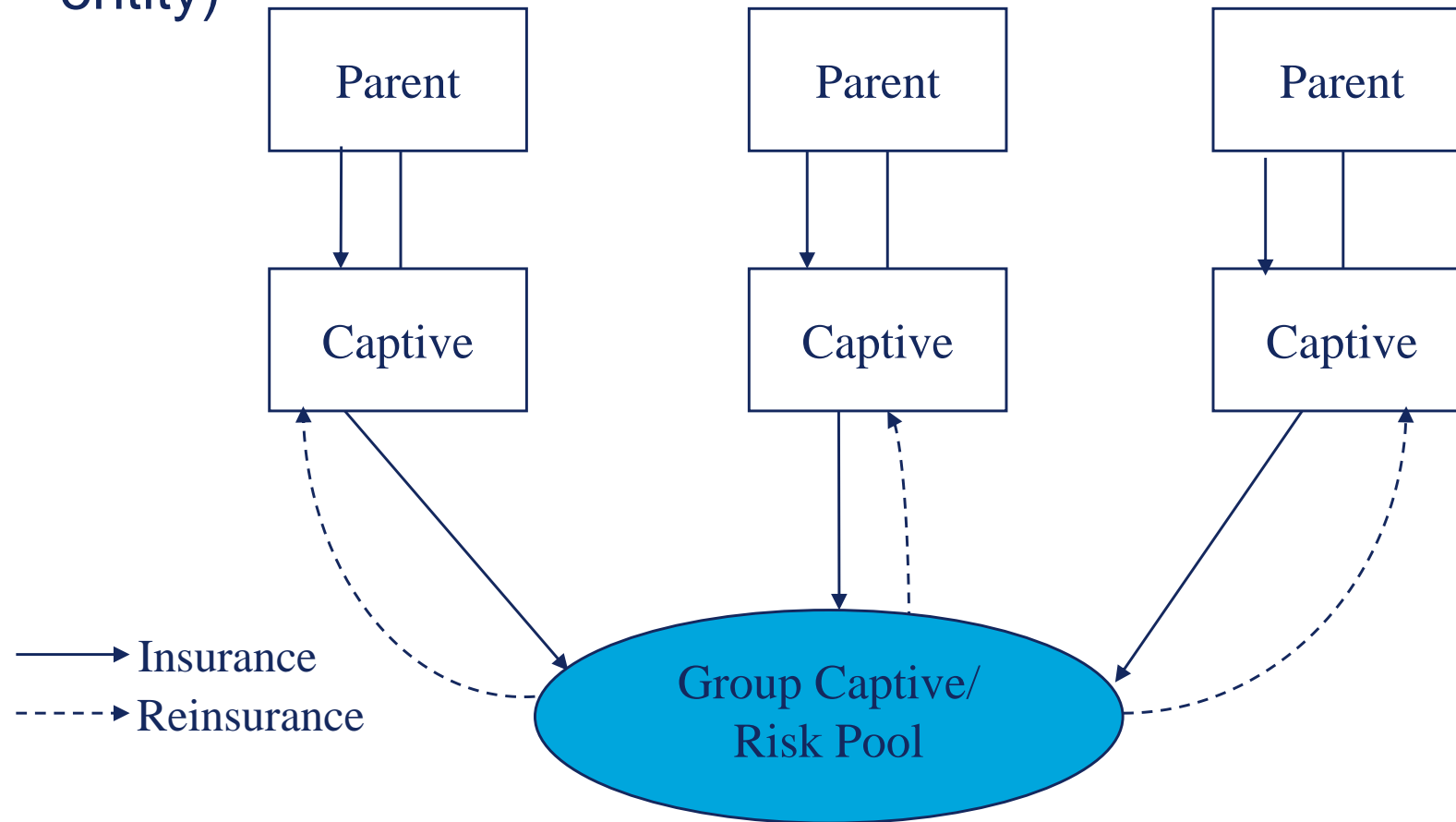
- Protected Cell (foreign) / Series LLC (domestic)



Note, diagram does not depict a valid insurance company arrangement.

Common Captive Structures (cont'd)

- Risk Pool (contractual arrangement) / Group Captive (legal entity)



Typical Individuals Associated with Captives

- Business owner(s)
- Attorney (tax and/or corporate)
- CPA
- Actuary
- Insurance producer (broker/agent)
- Insurance regulator
- Captive manager
- Claims manager/third-party administrator (“TPA”)

IRS's Challenges to Captive Insurance and Risk Pool Arrangements

Contexts for IRS Challenges to Captive Insurers

- Income tax examination
 - Insured: Deduction of premiums paid by the business to the captive
 - Captive: Deduction for discounted insurance reserves, unearned premiums, validity of section 831(b) election, etc.
- Promoter examination
 - Attorney, CPA, Insurance producer, Actuary etc.
- Criminal investigation (IRS / USAO)
 - Fraudulent schemes
- Application for or examination of section 501(c)(15) exemption
- FET examination
 - Whether and how much excise taxes result from re/insurance arrangements
 - “Cascading” FET for foreign reinsurers – Rev. Rul. 2008-15 and Ann. 2008-18

Requirements of Valid Captive

- **Economic substance / business purpose**
- Insurance company
 - **Insurance risk**
 - **Risk shifting**: Transfer of financial consequences resulting from potential loss from insured to insurer
 - **Risk distribution**: Pooling of a large number (mass) of independent, and potentially homogenous, loss exposure units (risks); involves the statistical phenomenon known as the law of large numbers
 - **Insurance in the commonly accepted sense**
- See, e.g., *Helvering v. LeGierse*, 312 U.S. 531 (1941); *AMERCO, Inc. v. Commissioner*, 96 T.C. 19 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992); *Harper Group v. Commissioner*, 96 T.C. 45 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992).

Issues with Economic Substance / Business Purpose

- Valid business purpose for the formation of the captive
 - Captive should not be a pure sham
 - Captive should not be formed primarily for tax purposes
- Premiums based on arm's length commercial rates
 - Premiums should not be based on the \$1.2 million section 831(b) exclusion. NSAR 020160 (April 17, 2002)
 - Premiums should not be based on deduction sought and/or the owner's available cash flow. *Salty Brine I, Ltd. v. U.S.*, Docket No. 10-cv-108 (N.D. Tex. May 16, 2013) and consolidated cases and related indictment ("Salty Brine").
- Adequate capitalization
 - Use of guarantees?
 - Use of indemnification or hold-harmless agreements?
 - Use of letters of credit?
- No circular cash flows
 - Use of loan-backs?
 - Investment by the captive in the owner's affiliated companies?
- No significant investment by captive in life insurance. *Salty Brine*.

Issues with Economic Substance / Business Purpose

- Captive insurer pays claims from its own funds, which are separately maintained from the insured
- Captive's business operations and assets are kept separate from the insured
- Captive is not loosely regulated by its domicile

Issues with Insurance Risk

- Business vs. insurance risks
 - Loss of key employee, customer, supplier, etc.
- Investment vs. insurance risks
 - Residual value insurance
- Low frequency risks
 - Natural disasters, terrorism
- Coverage after the loss has occurred is not insurance. Rev. Rul. 89-96
- IRS requested comments on finite risk insurance. Notice 2005-49.

Methods to Obtain Risk Distribution

1. Sufficient brother-sister insureds. *Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), *aff'g* 88 T.C. 197 (1987)
2. Sufficient unrelated risk. *Harper Group v. Commissioner*, 979 F.2d 1341 (9th Cir. 1992), *aff'g* 96 T.C. 45 (1991)

Issues with Risk Distribution

Method #1

- Significant exposure units alone is not sufficient. PLR 200837041 (Jun. 4, 2008)
- Number of insureds required?
 - Rev. Rul. 2002-90 – 12 brother-sister insureds each with between 5-15% premium volume
 - Rev. Rul. 2002-91 – Suggests 7 group captive insureds are sufficient (each with less than 15% ownership, vote and premium volume)
 - PLR 200837041 suggests 5 insureds are sufficient
 - Rev. Rul. 2005-40 - One insured is not sufficient
 - 12 disregarded LLCs held by one owner are not sufficient because just one insured for tax purposes.
 - 12 LLCs are sufficient if classified as corporations for tax purposes.
 - Gulf Oil, 89 T.C. 1010 (1987) and FSA 1998-578 (April 1, 2002) – suggest that one insured can be sufficient

Issues with Risk Distribution

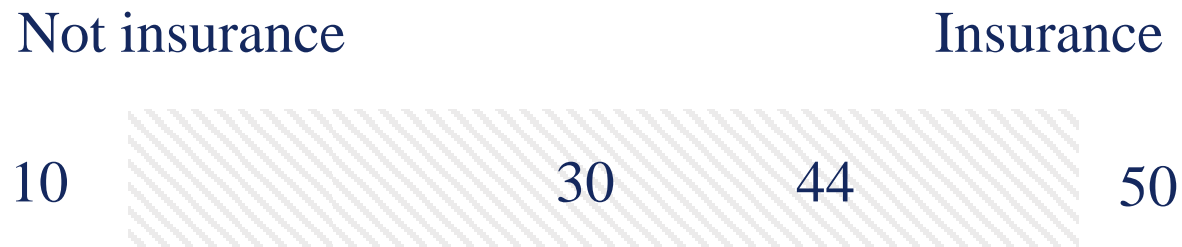
- Reinsurance context
 - Risk distribution is determined by looking through to the insureds on the underlying policies. Rev. Rul. 2009-26 (direct), PLRs 200950016 and 200950017 (layers)



Issues with Risk Distribution

Method #2

- Amount of unrelated risk required?
 - *Gulf Oil* (Tax Court): 2% unrelated is not sufficient
 - *Harper* (9th Cir): 30% unrelated is sufficient
 - *ODECO* (Fed. Cl.): 44% unrelated is sufficient
 - Rev. Rul. 2002-89:
 - 50% unrelated is sufficient
 - 10% unrelated is not sufficient



Issues with Risk Distribution

- Homogeneity: Risks in the same line of coverage
 - Issue: Is risk distribution tested in the aggregate or line-by-line?
 - No court has required homogeneity
 - FSA 1998-578 (April 1, 2002), Rev. Rul. 2002-89 and Rev. Rul. 2005-40 suggest that the IRS requires homogeneity
 - Notice 2005-49 sought comments on the relevance of homogeneity
 - ILM 200849013 (July 24, 2008) instructed Exam to determine whether homogeneity is a relevant factor

Issues with Insurance in the Commonly-Accepted Sense

- No underwriting by the insurer, e.g., premiums not actuarially priced based on insured's risk profile
- No policies issued
- Late premium and claim payments
- Retroactive premium or policy adjustments
- Validity of claims established before payments are made
- Captive not operating in conformity with its policies and procedures
- Insured-developed loss prevention programs

Authorities on Risk Pooling Arrangements

- CCA 200844011 (Oct. 31, 2008)
 - Contractual pooling arrangement
 - “Pool” constitutes a foreign entity such that premiums paid are subject to FET
- PLR 200907006
 - Company that participated in a reinsurance pool with several unrelated insurers qualified as an insurance company
- PLR 201126038
 - Denial of tax exempt status
 - 30 percent of the company’s risks was unrelated insurance through reinsurance and a reinsurance pool
 - IRS suggested that an insurance company must have both sufficient number of insureds and sufficient unrelated business
- PLRs 201224018, 201219011, 201219010, 201219009 and 201030014
 - Taxpayers were valid insurance companies
 - Each taxpayer’s risks for each line of business were those of at least 12 underlying insureds with no single underlying insured representing more than 15 percent of taxpayer’s total risk

Issues with Risk Pooling Arrangements (cont'd)

- May involve low frequency risks
 - Constitute insurance?
 - Premium amounts actuarially priced based on risk?
 - No claims payments
- Segregated accounts used to receive premiums, disburse reinsurance premiums and/or pay claims of the participants
- Homogeneity
 - Ex. Parent obtains traditional coverage from captive and captive obtains unrelated business using a specialty line (e.g., catastrophic risks such as natural disasters or terrorism)
- Issues raised in connection with insurance in the commonly-accepted sense

Issues with Cell / Series Companies

- Classification of cell/series for Federal tax purposes is determined at the cell/series level
 - PLR 200803004 (Jan. 18, 2008)
 - Prop. Treas. Reg. 301.7701-1(a)(5) (2010)
- Whether an arrangement is insurance is determined at the cell/series level
 - Rev. Rul. 2008-8 (Feb. 4, 2008)

Pending Captive Cases

- *Rent-A-Center, Inc. v. Commissioner*, Docket Nos. 8320-09, 6909-10 & 21627-10 (awaiting decision)
- *Securitas Holdings, Inc. v. Commissioner*, Docket No. 21206-10 (awaiting decision)
- *Dielco Crane Service v. Commissioner*, Docket No. 21726-10
- *Pilgrim's Pride v. Commissioner*, Docket No. 16972-10
- *Proliance Surgeons v. U.S.*, Docket Nos. 1:09-cv-680 & 1:10-cv-00641 (Ct. Cl.)
- *Vincent Enterprises, Inc. v. Commissioner*, Docket No. 2759-10
- *YRC v. Commissioner*, Docket Nos. 6714-10, 27592-11, 27611-11 & 27612-11

Procedural Issues Involving Captives

- An examination team may obtain taxpayer information relating to unrelated taxpayers that used the same captive or pool program. CCA 201250020 (Dec. 14, 2012). See also CCA 200048039 (Dec. 1, 2000).
- Attorney-client privilege may not apply given that information is typically disclosed to a number of parties when forming a captive and/or participating in a pool
- Role of National Office in the Appeals process
- Where captive is found not to be a valid insurance company for some or all of the years at issue
 - Premium deductions may be disallowed
 - Is the disallowance of insurance company status a change in method of accounting such that a section 481 adjustment is applicable?
 - Does the captive's section 953(d) election remain valid? If terminated, see *Chapman Glen Limited v. Commissioner*, 140 T.C. No. 15 (May 28, 2013)
 - Potential gift tax consequences if captive is owned by business owner's family members or trust for their benefit

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