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Captive Insurance: Feds Promote Tax Benefits, but Pay Attention to the Details

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Recent IRS rulings and a U.S. Tax Court decision continue to lay a solid foundation for captive insurance companies. However, the tax requirements must be strictly followed. Below we provide an update to assist captives in achieving their tax objectives.

A captive insurance company (or "captive") is an insurance company formed under the laws of and regulated by a state or foreign jurisdiction by a business to insure (or reinsure) the risks of that business or of related or affiliated entities. A captive can convert non-tax deductible self-insured risk into tax deductible insurance premiums while satisfying a variety of business purposes, including augmenting existing commercial coverage, providing access to the reinsurance market, and providing insurance for risks where commercial coverage costs are economically unattractive.

General guidance. The captive must be an "insurance company" and issue "insurance," as defined for federal income tax purposes. In addition, the captive needs to be adequately capitalized, and premiums must be actuarially determined and not excessive. The captive must also be operated in a commercially reasonable manner and satisfy legitimate, non-tax business purposes. In addition, it must provide coverage for insurable risks.

Defining "insurance company." For tax purposes, qualifying as an "insurance company" generally means that more than half of the captive's business must be issuing insurance or annuity contracts or reinsuring risks.

An example of this can be seen in Revenue Ruling 2014-15 (May 9, 2014), in which the taxpayer maintained a single-employer voluntary employees' beneficiary association, or "VEBA," to provide health benefits coverage to retired employees and their dependents. The VEBA secured accident and health coverage from an independent life insurance company (IC). To reduce the cost of the premiums, the taxpayer formed a subsidiary captive insurance company which issued a contract of reinsurance to IC. Because the reinsurance contract was the captive's sole business and only reinsurance contract, the captive qualified as an "insurance company" for tax purposes.

Defining "insurance." For a captive's insurance or reinsurance contracts to qualify as "insurance" for tax purposes, there must be "risk shifting" (i.e., the risk of an economic loss must be transferred from the insured to the captive) and "risk distribution" or spreading the risk of loss among numerous policyholders.

An example of this can be seen in the same Revenue Ruling as above. Although the reinsured risks were insured by the VEBA, they were risks of loss of the retired employees and their dependents. Thus, the risks that were shifted to the captive were not those of the taxpayer or the VEBA, but of the retirees. Likewise, there was risk distribution because the risks were those of a large number of retirees and their dependents.

Another example is found in Letter Ruling 201419007 (January 29, 2014). In this ruling, a captive was formed to issue extended warranties to a taxpayer's customers. Risk shifting and risk distribution were present, because the risks of economic loss were those of the taxpayer's customers (their costs of repair) and a large number of customers purchased the extended warranties.

Safe harbors. Since 2000, the IRS has issued a number of "safe harbor" rulings concerning captives. Although the rulings have addressed a variety of fact patterns and types of captives, they have predominantly focused on how the IRS will apply the risk distribution requirement for "insurance." Despite some IRS flexibility towards captives, it will still challenge captive insurance arrangements that it perceives as abusive. For example, so-called "notional risk pools," related party guarantees, premium loan-backs, certain IRC § 831(b) "small captives," and other issues are audit focus areas of the IRS.

Risk distribution. While the IRS has abandoned some historical audit positions on questions of risk shifting, it has been giving intense scrutiny to risk distribution. Despite that scrutiny, earlier this year in *Rent-A-Center, Inc. v. Commissioner (Jan. 14, 2014)*, the U.S. Tax Court focused on the number of "statistically independent risks" insured by the captive in finding that risk distribution was satisfied, as opposed to the "safe harbor" rulings.

When properly planned and implemented, a captive insurance company can serve a valuable business and tax planning function. If you have questions about the federal and state tax treatment of captive insurance companies, please reach out to any of our Tax attorneys, and to any of our Insurance Regulatory Group attorneys for questions about state regulation of captive insurance companies.