



**Federal Bar
Association**

37th Annual

INSURANCE TAX SEMINAR

June 2-3, 2022

JW Marriott • Washington, D.C.

A Dialogue with Government Personnel on Insurance Company and Product Tax Issues

Captive Insurance Primer

#FBA

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Speakers

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Agenda

- Overview of captive insurance companies
- Overview of federal tax considerations
- Federal tax law requirements to qualify as insurance
- Recent developments

Overview of Captive Insurance Companies

- A captive insurance company is a closely held insurance company that primarily insures risks of its owners and affiliates.
- What types of risks can a captive insure?

Traditional Risks

- Professional and general liability
- Product liability and recall
- Automotive insurance
- Workers' compensation
- Medical expense cost reimbursement or Medical Stop-Loss
- Property insurance

Nontraditional Risks

- Cyber liability
- Non-damage business interruption (NDBI)
- Loyalty programs
- Asset valuation / asset protection
- Longevity risks (pension plans)
- Pandemic (can be a part of NDBI)
- Extended warranty / consumer product service contracts
- Other advanced or specifically designed programs to cover risks unique to an organization, market or sector

Overview of Captive Insurance Companies

- A properly structured captive insurance program can provide a variety of benefits to the business, some of which can be easily computed while others will require a captive to be in operation before the benefit may be quantified. Some of those benefits are below:

Operational Benefits

- Reduced cost of coverage
- Obtaining coverage that may not be available or cost prohibitive in a “hard” market
- Ability to plan/supplement for employee benefits related expenses
- Centralization of risk management
- Lowering of the capital requirements through risk pooling
- Efficient investment of reserves
- Flexibility in insurance policy language
- Tax-efficient risk financing and capital management

Business Benefits

- Direct access to reinsurance market
- Access to Terrorism Risk Insurance Act
- Provision of desired vs. available coverage
- Certification of insurance coverage
- Mitigation of market swings impact on commercial insurance pricing
- Predictable costs at subsidiary level
- Spreading of risks among affiliated group
- Improved risk retention capability
- Better management of certain large future exposures

Overview of Captive Insurance Companies

- Captive Market – Growth Path
 - Domestic
 - Over 42 states with captive laws on the books
 - Significant competition between on-shore domiciles as well as with off-shore jurisdictions
 - Premium tax breaks
 - Self-procurement tax planning
 - Exemptions for certain lines of business
 - Certain programs can be written only through on-shore captives
 - State & Local tax considerations
 - Generally shorter timeline for “captive stand up” as compared to 5–10 years ago

Overview of Captive Insurance Companies

- Captive Market – Growth Path
 - Offshore
 - Very mature market
 - Simpler access to global programs
 - Extremely competitive capital and funding programs
 - Shorter time for “captive stand up” as compared to US
 - Access to reinsurance markets

Overview of Captive Insurance Companies

- Why now (specifically)?
 - “Hard” insurance market, resulting in rapidly rising premiums, decreased market capacity and reduction of available insurance products in the commercial market
 - Renewed focus on cash and expenses at the C-Suite level
 - New and varied risks affecting organizations domestically and globally (e.g., Pandemic, Non-Damage Business Interruption, Cyber, etc.) that will continue to impact each organization’s risk management function

Overview of Captive Insurance Companies

- Captive market expansion ... what else can be included?
 - Property – increase capacity and to access reinsurance markets
 - Cyber and digital
 - Medical Stop Loss or cost containment policies – specific and aggregate
 - Health and Benefits
 - Voluntary benefits
 - Pet insurance, auto, electronics, homeowners, etc.
 - Long Term Disability
 - Short Term Disability
 - Accidental Death & Dismemberment
 - Group Life
 - Pension longevity or valuation risks
 - ESG considerations

Overview of Captive Insurance Companies

- Captive market expansion ... what else can be included?
 - Retail Shrinkage
 - Asset Retirement Obligations
 - Non-damage business interruption & supply chain (i.e. Pandemic)
 - Trademark/Patent – Intellectual Property
 - Captives as revenue generators
 - Extended Warranty Insurance
 - Phone Handset Insurance
 - Renters Insurance
 - Forced Placed Insurance
 - Supplier Insurance (altruism and profit in one!)
 - Reputation and Brand
 - Integrated risk programs

Overview of Federal Tax Considerations

- Tax treatment of the insured
 - When a company buys insurance, premiums are generally deductible under section 162 as an ordinary and necessary business expense.
 - Alternatively, if a company forgoes insurance, a deduction for losses incurred is generally taken into account in the taxable year in which all the events have occurred to establish the liability, the liability can be determined with reasonable accuracy and economic performance has occurred with respect to the liability (e.g. the loss is paid).
 - Special considerations when the insurance company is related to the insured entity
 - Over the last 40 years, the courts and the IRS have considered whether premium payments made to related insurance companies are deductible.

Overview of Federal Tax Considerations

- Tax considerations for the captive
 - Accelerated timing for loss deductions; deductions permitted when loss is incurred, which does not require discovery or receipt of claim (i.e. incurred but not reported losses (“IBNR”) and claim payment case reserves (exceptions from the all events test)
 - Deferral of 80% of collected but unearned premium reserve
 - May be formed as domestic or off-shore (foreign) company. If offshore, may elect to be treated as a US company for tax purposes
 - Under the consolidated group regulations an insurance company’s intercompany transactions are respected (e.g. not eliminated) upon consolidation. Treas. Reg. § 1.1502-13.

Section 953(d) Election

- Treats a foreign insurance company as a US insurance company for US tax purposes
- Common election for foreign captives insuring US risks
- Pros:
 - Avoids federal excise tax (FET) on insurance premiums (up to 4% tax on gross premiums for Property & Casualty policies)
 - Avoids subpart-F income and GILTI inclusion
- Cons:
 - Causes the non-US underwriting results within the foreign electing insurance company to be subject to US tax (21% tax on taxable income)

Section 953(d) Election

- Main election requirements:
 - The foreign company must be a CFC (i.e., more than 50% US ownership)
 - Must meet the criteria of being an “insurance company” for federal tax purposes
 - More than 50% of the business must be from issuing insurance contracts or reinsuring insurance risk
 - The 953(d) election is only available to insurance companies!

Section 953(d) Election

- IRS guidance:
 - IRS Notice 89-79 (July 1989)
 - Rev. Proc. 2003-47

Section 953(d) Election

Ways to meet the requirements to make the election

1. Foreign insurance company directly satisfies the “US Office” and “US Assets” tests
 - Must have an office in the US and have assets in the US equal to 10% of its revenues
2. Use a U.S. affiliate to meet the “US Office” and “US Assets” tests
 - Requires the U.S. affiliate to enter into an IRS closing agreement
3. Foreign insurance company enters into an IRS closing agreement and posts a letter of credit between \$75K to \$10M (depending on amount of revenues)

Tax Law Requirements to Qualify as “Insurance”

- Insurance is not defined in the Code or regulations
- Case law has established the following requirements:
 1. Insurance risk
 2. Risk shifting
 3. Risk distribution
 4. Commonly accepted notions of insurance

Insurance Risk

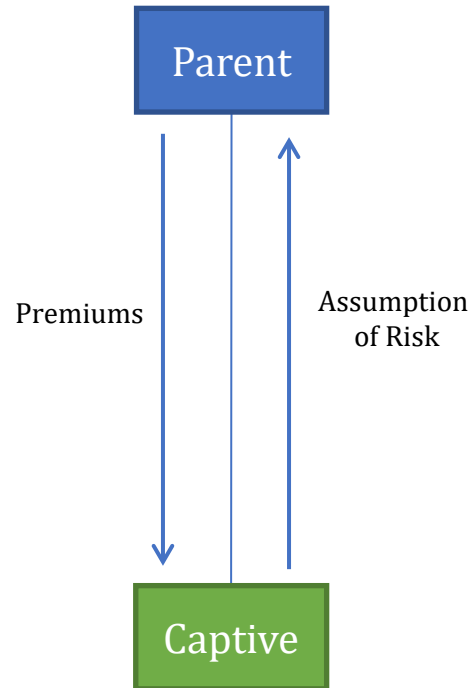
- Investment risk not sufficient
- Fortuity required = a chance occurrence
 - Risk of an economic loss that may occur as a result of a fortuitous occurrence of a stated contingency
- *R.V.I. Guar. Co. v. Commissioner*, 145 T.C. 209 (2015)
 - Non captive Tax Court case that expanded or clarified business risks that may be captured within an insurance contract, specifically allowing residual value insurance as valid insurance

Risk Shifting & Risk Distribution

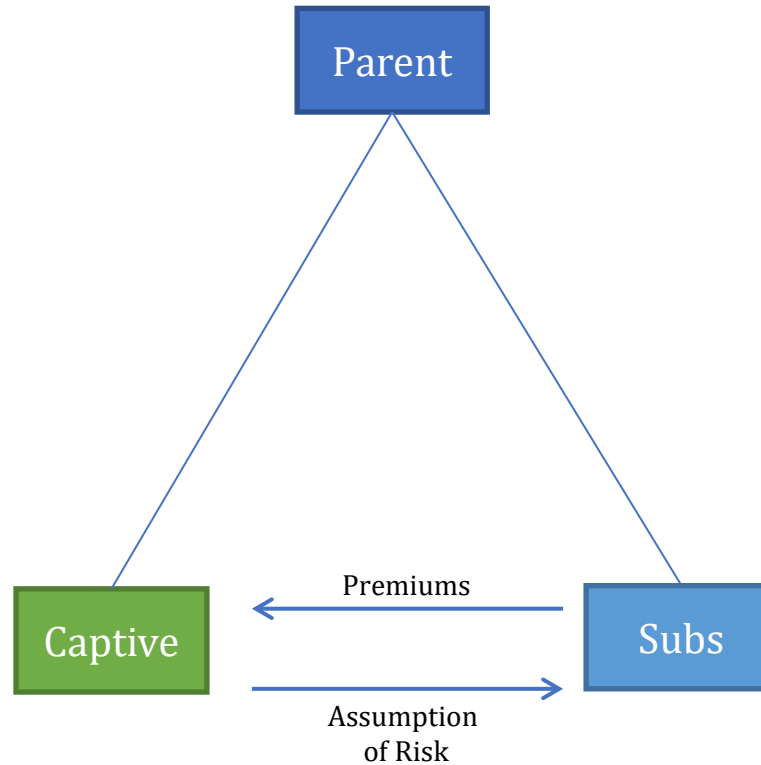
- Facts and circumstances determinations
- Risk shifting requires transfer of some or all the financial consequences of a potential loss from the insured to the insurance company
- Risk distribution requires shifted risk to be spread across multiple insureds or units of risks

Risk Shifting & Risk Distribution

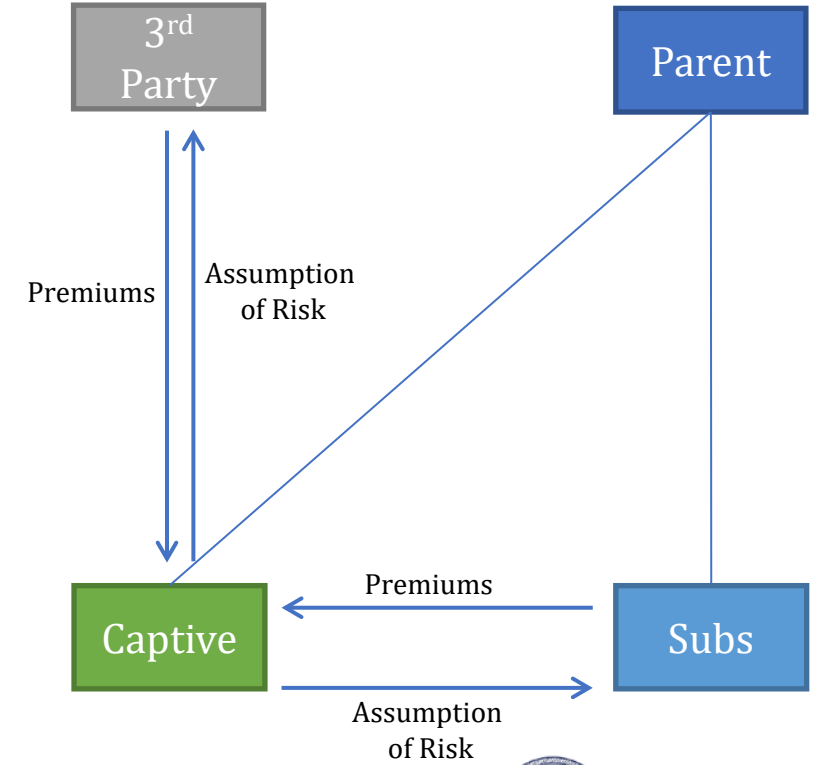
Parent-Subsidiary Arrangements



Brother-Sister Arrangements



Unrelated Parties



Risk Shifting & Risk Distribution

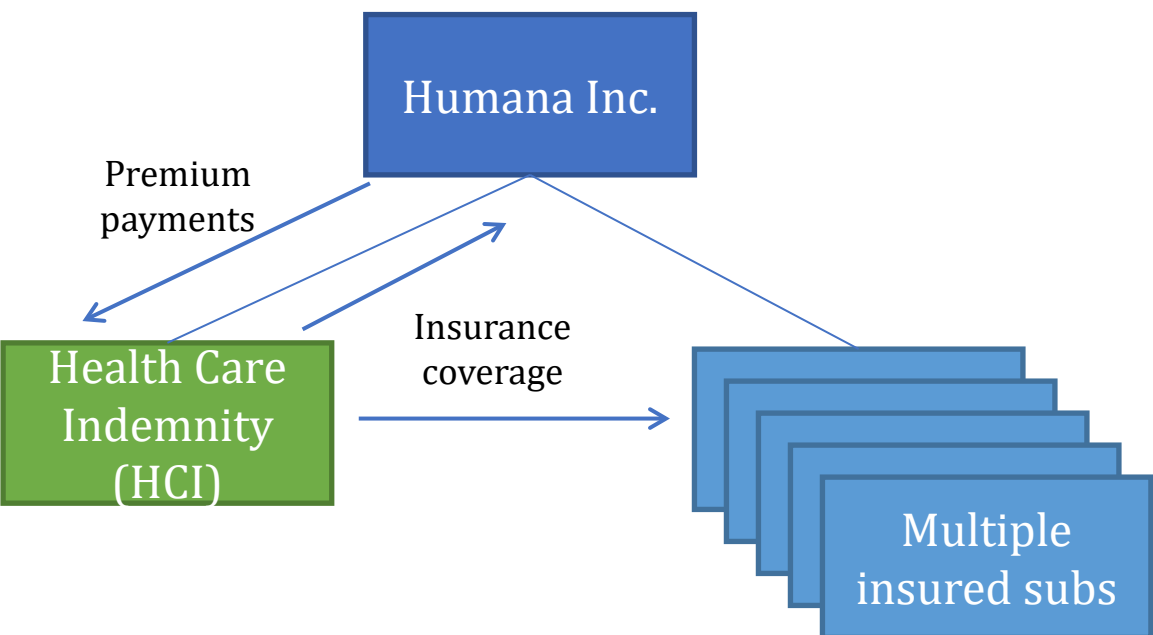
Parent to Captive Arrangements

- Unlikely to meet the risk shifting and risk distribution requirements
- Under the “balance sheet/net worth” analysis, no risk shifted from parent to captive
- *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989); *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985), *aff’d*, 811 F.2d 1297 (9th Cir. 1987); *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), *aff’d*, 640 F.2d 1010 (9th Cir. 1981).
- Rev. Rul. 2008-8

Risk Shifting & Risk Distribution

Humana Inc. v. Commissioner

- HCI issued insurance policies covering Humana Inc. and its subsidiaries. During years at issue, policies covered:
 - 22 & 48 entities in the Humana group
 - Approximately 60-100 hospitals
- Humana paid premiums to HCI and allocated a portion to each covered entity based on share each bore for hospitals each operated
- IRS disallowed the entire amount of premiums based on its “economic family” theory
- Tax Court sustained the IRS’s determination
- Sixth Circuit held that:
 - Parent-subsidiary arrangement did not qualify as insurance
 - But brother-sister arrangement qualified



Risk Shifting & Risk Distribution

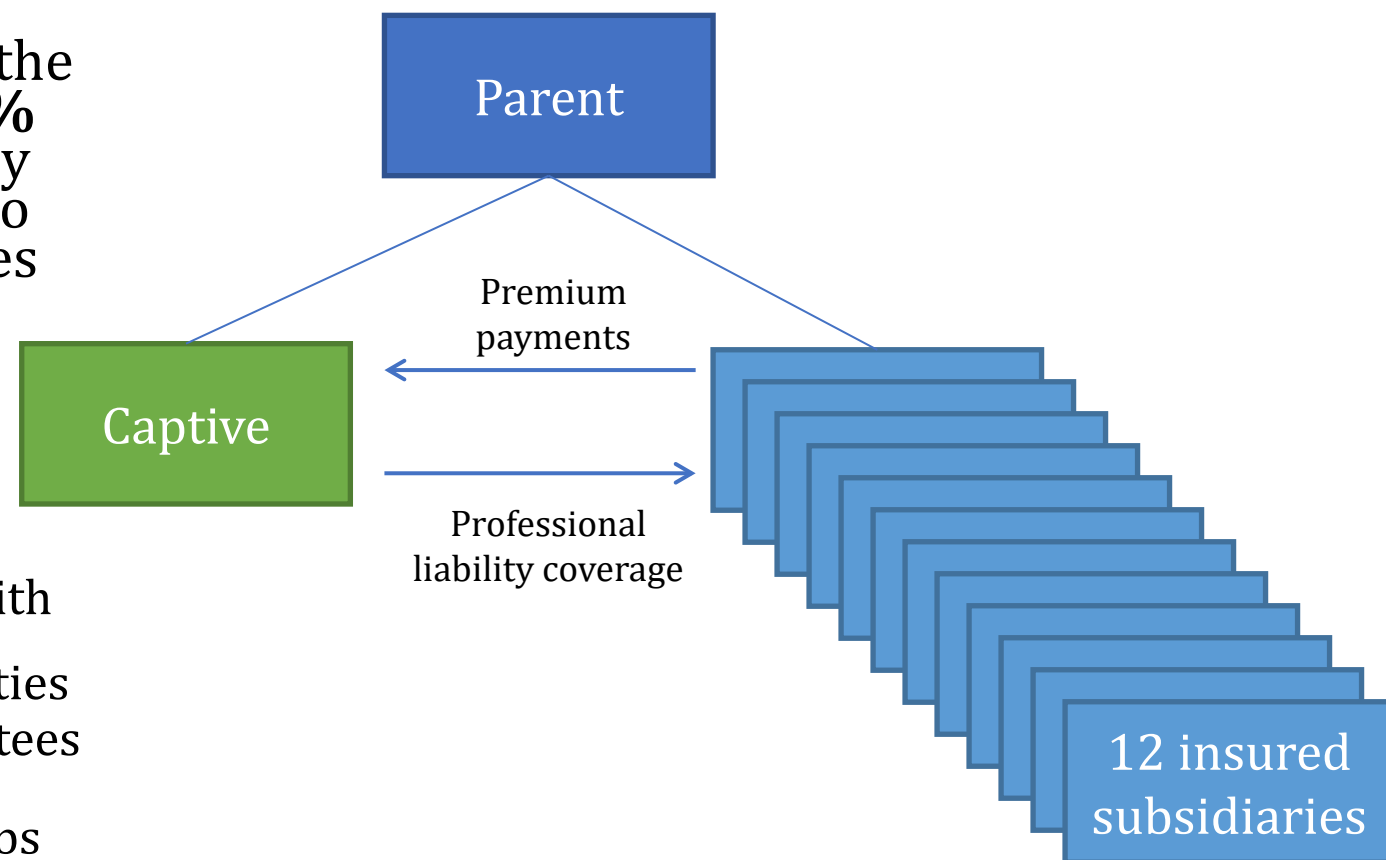
Brother-Sister Arrangements

- *Securitas Holdings, Inc. v. Commissioner*, 108 T.C.M. (CCH) 490 (2014); *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014); *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989).
- Other factors may affect qualification
 - *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396 (3d Cir. 1990) (captive was initially undercapitalized and parental guarantees in place)
 - *Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995) (distinguished from *Humana* in that captive was undercapitalized, parental guarantees in place, and no legitimate need for captive insurance)
 - *Kidde Indus., Inc. v. United States*, 40 Fed. Cl. 42 (Fed. Cl. 1997) (parent retained risk of loss to the extent indemnity agreement was in place)

Risk Shifting & Risk Distribution

Rev. Rul. 2002-90; Rev. Rul. 2005-40

- Qualifies as insurance when each of the **12 operating subs had between 5% and 15%** of the total risks insured by Captive; latter ruling required subs to be treated as separate taxable entities (corporations, not DREs)
- Other relevant facts:
 - Captive adequately capitalized
 - Premiums established according to customary industry rating formulas
 - Conduct of the parties is consistent with standards applicable to insurance arrangements between unrelated parties
 - No parental (or related party) guarantees made in Captive's favor
 - No loans from Captive to Parent or subs



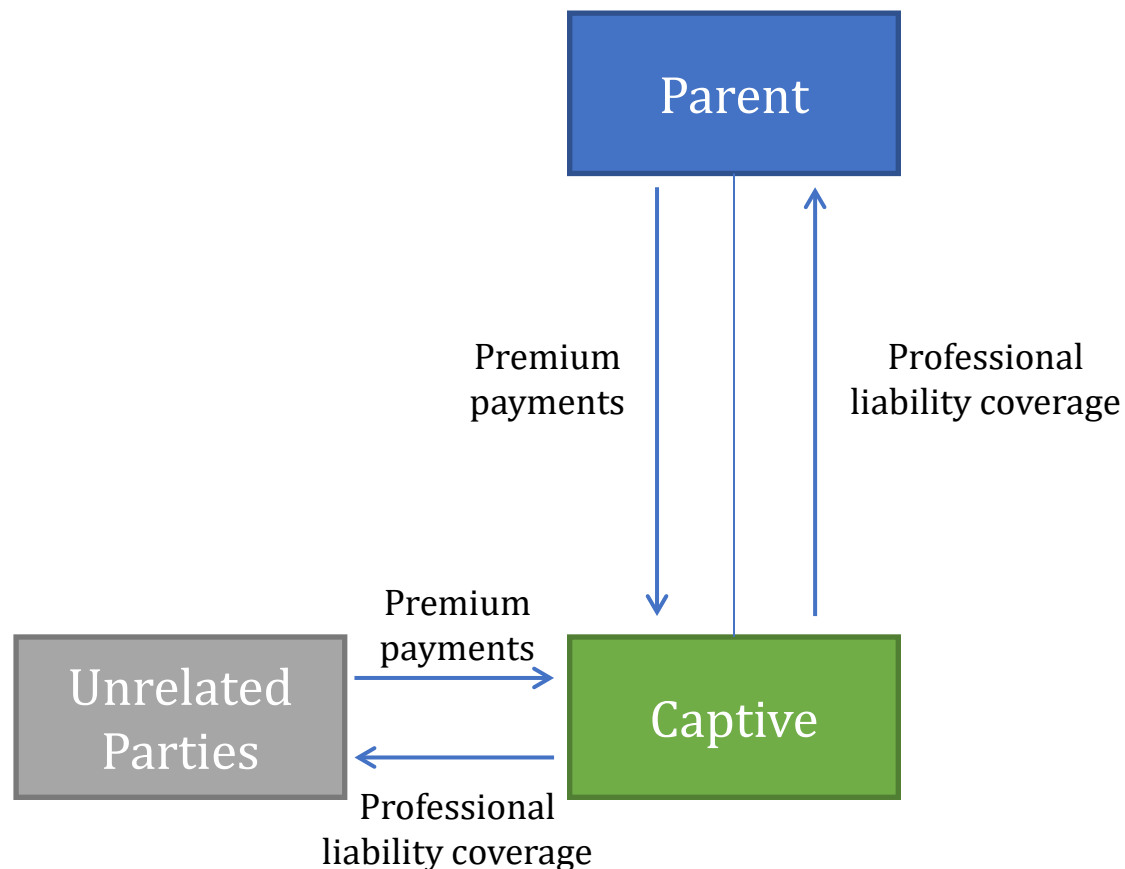
Risk Shifting & Risk Distribution

Presence of Unrelated Risks

- *The Harper Grp. & Subs. v. Commissioner*, 96 T.C. 45 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992) (**30%** from unrelated parties)
- *AMERCO, Inc. v. Commissioner*, 979 F.2d 162 (9th Cir. 1992), *aff'g* 96 T.C. 18 (1991) (**52% to 74%** from unrelated parties)
- *Ocean Drilling & Expl. Co. v. United States*, 24 Cl. Ct. 714 (Cl. Ct. 1991), *aff'd per curiam*, 988 F.2d 1135 (Fed. Cir. 1993) (**44% and 66%** from unrelated parties)

Risk Shifting & Risk Distribution

Rev. Rul. 2002-89



- Not insurance when Captive earned 90% of total premiums (on a gross and net basis) from Parent
- Qualifies as insurance when Captive earned **less than 50%** of total premiums (on a gross and net basis) from Parent
- Other relevant facts:
 - Premiums established according to customary industry rating formulas
 - Conduct of the parties is consistent with standards applicable to insurance arrangements between unrelated parties
 - Parent does not guarantee captive's performance
 - Funds and business records are separately maintained
 - No loans from Captive to Parent

Risk Shifting & Risk Distribution

Number of insureds v. units of statistically independent risks

- *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014)
 - Brother-sister captive arrangement; no unrelated insureds
 - Captive insured three types of risk: workers' compensation, automobile, and general liability. Insureds owned between 2,623 and 3,081 stores; had between 14,300 and 19,740 employees; and operated between 7,143 and 8,027 insured vehicles.
 - Court found the captive achieved adequate risk distribution by insuring Rent-A-Center's subsidiaries, which had "a sufficient number of statistically independent risks."

Risk Shifting & Risk Distribution

Number of insureds v. units of statistically independent risks

- *Securitas Holdings, Inc. v. Commissioner*, 108 T.C.M. (CCH) 490 (2014)
 - Similar fact pattern
 - “As a result of the large number of employees, offices, vehicles, and services provided by the U.S. and non-U.S. operating subsidiaries [insured parties], SGRL was exposed to a large pool of statistically independent risk exposures. This does not change merely because multiple companies merged into one. The risks associated with those companies did not vanish once they all fell under the same umbrella ... It is the pooling of exposures that brings about the risk distribution—who owns the exposures is not crucial.”

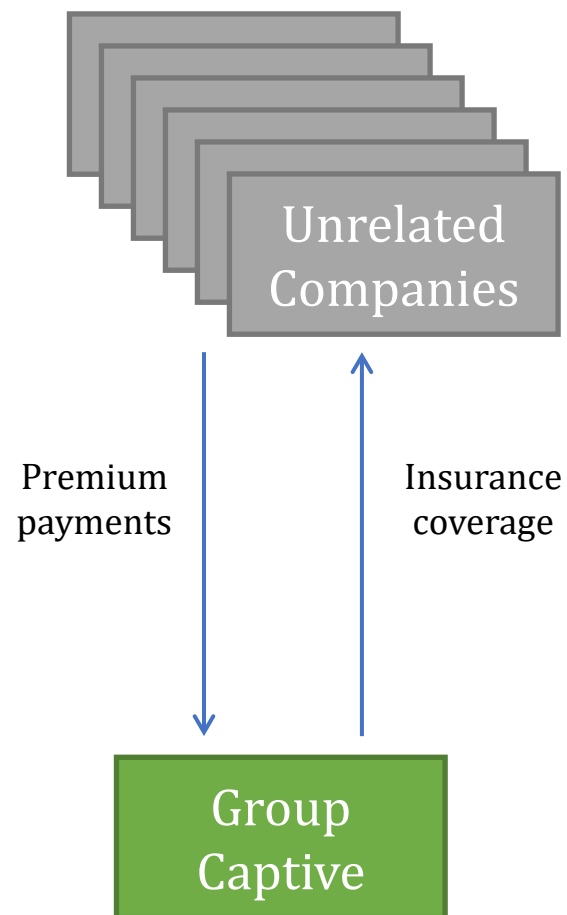
Risk Shifting & Risk Distribution

Number of insureds v. units of statistically independent risks

- *Caylor Land & Dev., Inc. v. Commissioner*, 121 T.C.M. (CCH) 1205 (2021)
 - Involved a section 831(b) micro-captive case; no risk pool
 - Tax Court found no risk distribution
 - No unrelated party risks
 - Did not meet the safe harbor in Rev. Rul. 2002-90
 - Insufficient number of independent risk exposures
 - 12 independent exposures for administrative action and legal expense reimbursement
 - 11 independent exposures for loss of key contracts
 - 10 for cyber liability, miscellaneous professional liability, and professional services reimbursement
 - 1 for extended warranty
 - The risks were not independent because the insured affiliates were highly dependent on the parent

Risk Shifting & Risk Distribution

Rev. Rul. 2002-91



- Qualifies as insurance when several unrelated companies in the same industry formed a Group Captive (GC) in which no company owned more than 15% of GC or had more than 15% of the vote for corporate governance issues, and no company's individual risk insured by GC exceeded **15% of total risk** insured by GC
- Other relevant facts:
 - Need for insurance coverage not readily available in commercial market
 - Arm's length premiums
 - GC is adequately capitalized
 - GC investigates validity of claims before payment
 - No company obligated to pay GC additional premiums if losses exceed premiums paid (or vice versa)

Commonly Accepted Notions of Insurance

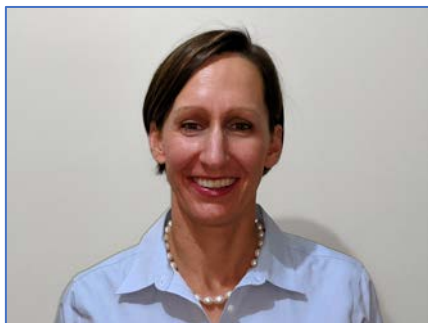
- Relevant factors include whether:
 - The insurer was organized, operated, and regulated as an insurance company
 - The insurer was adequately capitalized under local law
 - The insurance policies were valid and binding
 - The premiums were reasonable
 - Losses paid only when claims covered under contract

See, e.g., Securitas Holdings, Inc. v. Commissioner, 108 T.C.M. (CCH) 490 (2014).

Recent Developments

- Section 831(b) captives
- Recent cases
 - *Reserve Mechanical Corp. v. Commissioner*, 115 T.C.M (CCH) 1475 (T.C. 2018), *aff'd*, No. 18-9011, 2022 WL 1510373 (10th Cir. May 13, 2022)
 - *Caylor Land & Dev., Inc. v. Commissioner*, 121 T.C.M. (CCH) 1205 (T.C. 2021)
 - *Syzygy Ins. Co. v. Commissioner*, 117 T.C.M. (CCH) 1165 (T.C. 2019)
 - *Avrahami v. Commissioner*, 149 T.C. 144 (T.C. 2017)
- Notice 2016-66
 - *CIC Services, LLC v. IRS*, No. 3:17-cv-110 (E.D. Tenn. Mar. 21, 2022)

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