

**TAXATION OF CAPTIVE INSURERS
AND RELATED ISSUES**

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I. Self Insurance

A. Types of deductions allowed

1. Insurance premiums paid for property and casualty insurance are deductible if they are an ordinary and necessary expense incurred in a trade or business. Treas. Reg. § 1.162-1(a).
2. Losses compensated for by such insurance are not deductible. Treas. Reg. § 1.165-1(a).
3. Losses and payments made with respect to uninsured liabilities are deductible if incurred in connection with a trade or business. Section 165(a).

B. Timing of deductions

1. Controversies have arisen concerning the timing of deductions for amounts "credited" to "reserves" for self-insurance.
 - a. P&C insurers can hold reserve liabilities for "unpaid losses," including estimated losses incurred and resisted claims.
 - b. Treas. Reg. § 1.461-1(a)(2), applicable to non-insurance taxpayers, provides that an expense is accruable and may be deducted when all events have occurred that determine the fact of liability and the amount thereof can be determined with reasonable accuracy. See also section 461(h)(4).
 - c. In general, a taxpayer cannot accrue a deduction based upon a prediction that liability ultimately might be established. In other words, additions to a liability reserve for estimated losses are not deductible. E.g., Supermarkets General Corp. v. U.S., 537 F. Supp. 759 (D.N.J. 1982).
 - d. However, liability triggered by an event and imposed by law can be considered fixed under the all events test. E.g., Kaiser Steel Corp. v. U.S., 717 F.2d 1304 (9th Cir. 1983) (workmen's compensation); U.S. v. Hughes Properties, Inc., 476 U.S. 593 (1986).
 - e. Similarly, liability imposed by contract can be considered fixed under the all events test. E.g., Lukens Steel Co. v. Comm'r, 442 F.2d 1131 (3d Cir. 1971).

- f. However, the Supreme Court has held that the all events test does not go so far as to allow ordinary taxpayers to mirror the treatment accorded to P&C insurers. General Dynamics Corp. v. U.S., 6 Cl. Ct. 250 (1984), aff'd, 773 F.2d 1224 (Fed. Cir. 1985), rev'd, 87-1 U.S.T.C. ¶9280 (U.S. 1987).
2. Accrual method taxpayers are now subject to the "economic performance" test of section 461(h).
 - a. In the case of workmen's compensation and tort liabilities, this generally means that no deduction is allowed until actual payments are made to third parties. Section 461(h)(2)(C).
 - b. Section 461(h)(3) provides a "recurring item" exception to the economic performance requirement.
 - c. However, the recurring item exception does not apply to workmen's compensation and tort liabilities. Section 461(h)(3)(C).
 - d. The purpose of the economic performance requirement is to reflect the time value of money. Note that the method of "discounting" the liabilities of ordinary taxpayers differs from the method of "discounting" unpaid loss reserves of P&C insurers.
3. A deduction may be allowable for payments with respect to "contested liabilities" pursuant to section 461(f).
 - a. In general, if a taxpayer contests a liability, then that liability cannot be accrued under the all events test.
 - b. However, if the taxpayer transfers money or property beyond his control -- for example, to an escrow agent -- in satisfaction of the contested liability, then a deduction may be allowable in the year of the transfer. Although, in the case of workers, compensation and tort liabilities, the deduction is not allowed until payments are made to the claimant. Section 461(f)(4).
4. Often, the issue presented is whether the taxpayer has "paid" an insurance "premium."
 - a. A "payment" to the taxpayer's segregated bank account does not qualify.

- b. Likewise, a "payment" to an agent does not qualify. Spring Canyon Coal Co. v. Comm'r, 43 F.2d 78 (10th Cir. 1930), cert. denied, 284 U.S. 654 (1930).
 - c. As discussed below, payments of "premiums" to captive insurance companies may not qualify.
 - d. Even premium payments to an insurance company will not qualify if the arrangement is not insurance. Steere Tank Lines, Inc. v. U.S., 577 F.2d 279 (5th Cir. 1978), cert. denied, 440 U.S. 946 (1979).
5. Similar issues arise in connection with retrospectively rated insurance contracts.
- a. The IRS may challenge a retrospectively rated insurance arrangement as not being true "insurance." See LTR 8637003 (May 23, 1986); LTR 8638003 (June 11, 1986).
 - b. This issue is likely to receive additional attention by the IRS in the future.
6. "After-loss" insurance presents similar issues. See Rev. Rul. 89-96, 1989-2 C.B. 114; FSA 200209017 (Nov. 26, 2001) (recommending application of principles of Rev. Rul. 89-96 to situation where employer that was self-insured for 22 years obtained insurance potentially covering residual losses from the past 22 years); GCM 39795 (Apr. 15, 1982); GCM 35796 (May 1, 1974).
7. The IRS may raise other arguments in order to defeat the current deductibility of premiums.
- a. In Black Hills Corp. v. Comm'r, 73 F.3d 799 (8th Cir. 1996), an industry captive issued black lung coverage to its owner/policyholders. Premiums were payable currently (thus building up a reserve, which was refundable in certain circumstances), while claims for benefits were not expected until future dates.
 - b. Under INDOPCO, the court held that the premium payments must be capitalized.

II. Captive Insurance Companies

A. Captive insurance companies may be formed for a variety of reasons

1. Nontax motives

- a. To obtain insurance at lower cost
- b. To insure risks that are uninsurable in conventional insurance markets.

2. Tax motive

The primary tax motive is to obtain a current deduction for "premiums" paid to the captive.

B. Captives generally take one of two forms

1. Direct-writing captives

These captives issue policies to the insured and receive premiums from the insured.

2. Reinsurer captives

These captives assume business written by a direct writer, which is often referred to as the "fronting" company. See, e.g., Kidde Industries Inc. v. U.S., 98-1 U.S.T.C. ¶50,162 (Fed. Cl. 1998)(parent company could deduct the amount of premium payments made to third-party insurer that were not ceded back to the company's wholly-owned captive insurance company).

C. IRS Treatment of Captive Issues

1. The IRS treats captive insurance arrangements as a coordinated issue. The IRS has approved settlement guidelines with respect to captives. See, "IRS Updates ISP Settlement Guideline List," 2001 Tax Notes Today 190-18 (Sept. 27, 2001).
2. On December 10, 2002, the IRS issued Rev. Proc. 2002-75, 2002-52 I.R.B. 997, which revokes the IRS's previous "no ruling" policy regarding captive arrangements (see sections 4.01(11) and 4.01(41) of Rev. Proc. 2002-3, 2001-1 I.R.B. 117). The IRS will now consider ruling requests regarding the proper tax treatment of a captive insurance company.

D. Shifting of Risk Between Parent and Subsidiary Captive

1. The IRS views captive insurance arrangements not as actual insurance, but as no more than a form of self-insurance. The captive is considered an incorporated self-insurance reserve.
2. The result is the same whether the captive is the direct writer or the ultimate reinsurer.
3. Until recently, the IRS took the position that for a captive insurance arrangement to be respected, there must be a shifting of risk away from the "economic family." If the risk merely was shifted within an economic family - for example, from a parent to a subsidiary - then the IRS argued that no economic shifting of risk had occurred and no "insurance" existed. See, e.g., Rev. Rul. 77-316, 1977-2 C.B. 53; Rev. Rul. 88-72, 1988-2 C.B. 31.
4. In such a case, while the parent has shifted the responsibility for paying the loss to its subsidiary, the parent's investment in the subsidiary declines in value when the subsidiary pays the loss. Under this "balance sheet" analysis, there is no shifting of the risk.
5. Under the IRS's position, "premiums" paid are not deductible. Those payments are treated as capital contributions to the captive. "Benefits" paid by the captive are dividends to the extent of the captive's earnings and profits. The parent is entitled to deduct its losses, which are not compensated for by "insurance." Since there is no insurance, the captive cannot be taxed as an insurance company.
6. In the context of parent/subsidiary captive arrangements, where no insurance is issued to unrelated third parties, courts generally have reached the result sought by the IRS, although they have not adopted the IRS's economic family theory. E.g., Clougherty Packing Co. v. Comm'r, 811 F.2d 1297 (9th Cir. 1987).
7. In Rev. Rul. 2001-31, 2001-25 I.R.B. 1 (June 4, 2001), the IRS announced that because no court had fully accepted its economic family theory, it would no longer invoke the theory with respect to captive insurance arrangements. The IRS will continue to apply a "facts and circumstances" test to captive arrangements.
8. Rev. Rul. 2002-89, 2002-52 I.R.B. 984, involves two parent-subsubsidiary captive situations under which a captive subsidiary, S, provides professional liability insurance and reinsurance to its parent company, P, and to other parties unrelated to S or P. In the first situation, 90% of S's total premiums are received from P, and 90% of the risks borne by S are P's risks. In the second situation,

less than 50% of S's total premiums are received from P, and less than 50% of the risks borne by S are P's risks. The ruling holds that the first (90%) arrangement lacks the requisite risk shifting and risk distribution to constitute insurance for tax purposes and, thus, that premiums paid by P are not deductible as "insurance premiums" under section 162, but that the second (less-than 50%) arrangement possesses the requisite risk shifting and risk distribution to constitute insurance for tax purposes and, thus, that premiums paid by P are deductible as "insurance premiums" under section 162.

E. Brother/Sister Captive Arrangements

1. Applying the "balance sheet" test, the Sixth Circuit has held that, while insurance does not exist in a parent/subsidiary captive arrangement, it can exist in a brother/sister captive arrangement, since the insured does not own the captive. Humana, Inc. v. Comm'r, 881 F.2d 247 (6th Cir. 1989).
2. In Humana, there were over twenty insured entities, those entities were denied traditional insurance by unrelated insurers, the captive was adequately capitalized, and there were no indemnification or hold-harmless agreements.
3. In Malone & Hyde v. Comm'r, also involving a brother/sister arrangement, there were facts that negated risk shifting and led the court to find that there was no "insurance." 95-2 U.S.T.C. ¶ 50,450 (6th Cir. 1995). The insureds could have been insured by unrelated insurers, the captive was undercapitalized, and hold-harmless agreements negated the risk.
4. The IRS has conceded a number of captive issues involving brother/sister arrangements. See, e.g., FSA 200029010 (April 24, 2000); FSA 200043012 (June 19, 2000); FSA 200105014 (Oct. 26, 2000).
5. Rev. Rul. 2002-90, 2002-52 I.R.B. 985, involves a brother-sister captive situation under which a captive subsidiary, S, provides professional liability insurance directly to 12 operating subsidiaries of S's parent company, P. S does not provide insurance to any party unrelated to S or P. Each operating subsidiary's percentage of the total risk borne by S ranges from 5% to 15%. The ruling holds that the arrangement possesses the requisite risk shifting and risk distribution to constitute insurance for tax purposes and, thus, that premiums paid by the operating subsidiaries are deductible as "insurance premiums" under section 162.

F. Captives and Reinsurance Arrangements

1. To the extent insurance risks are retained within the economic family, premiums paid are not deductible. Rev. Rul. 77-316, 1977-2 C.B. 53. But see Humana.
2. To the extent insurance risks are transferred out of the economic family by reinsurance, premiums paid are deductible. But see Malone & Hyde.
3. The IRS has argued that the use of a wholly-owned offshore reinsurance company to shift income away from the U.S. parent company is a sham transaction lacking economic substance. The Eleventh Circuit held that such a transaction was bona fide and had economic effect. United Parcel Service v. Commissioner, 254 F.3d 1014 (11th Cir. 2001), rev'g T.C. Memo. 1999-268. See also, FSA 200027008 (March 31, 2000).
4. The IRS recently announced that it will challenge producer-owned reinsurance companies (“PORCs”) on three theories: (1) the reinsurer is not an “insurance company” for tax purposes; (2) premium income may be reallocated from the reinsurer to the taxpayer/owner under section 482 or 845; and (3) the arrangement is a sham in fact or a sham in substance. Notice 2002-70, 2002-44 I.R.B. 1. The PORC arrangement that the IRS is challenging is typically an offshore reinsurance company that is wholly owned by an insurance salesperson or salespeople, and reinsures risks under policies sold by its owners. These transactions are now considered “listed transactions” for purposes of tax shelter disclosure, registration, and list maintenance rules.

G. Third-Party Insurance Risks Assumed by Wholly-Owned Captives

1. The IRS initially ruled that a valid insurance arrangement exists when the captive has at least 50% unrelated insurance risks. O.M. 19167 (Sept. 28, 1979); GCM 38136 (Oct. 12, 1979); LTR 8111087 (Dec. 18, 1980).
2. The current position of the IRS is that third party insurance risk is irrelevant and that it will not create a valid insurance arrangement. GCM 39247 (June 27, 1984); Rev. Rul. 88-72, 1988- 2 C.B. 31.
3. In Gulf Oil Corp. v. Comm'r, 89 T.C. 1010, 1027 n.14 (1987) the Tax Court in dictum stated that a valid insurance risk may exist if the captive has at least 50 percent unrelated risks.
4. The courts have recognized that insurance exists in situations involving unrelated risks. See Sears, Roebuck & Co. v. Comm'r,

96 T.C. 61 (1991), aff'd, 92-2 U.S.T.C. ¶50,426 (7th Cir. 1992) (99% outside risk); AMERCO v. Comm'r, 96 T.C. 18 (1991), aff'd, 92-2 U.S.T.C. ¶50,571 (9th Cir. 1992) (over 50% outside risk); and Harper Group v. Comm'r, 96 T.C. 45 (1991), aff'd, 92-2 U.S.T.C. ¶50,572 (9th Cir. 1992) (30% outside risk). See also Ocean Drilling v. U.S., 92-1 U.S.T.C. ¶50,018 (Cl. Ct. 1991) (44-66% outside risk).

5. Treasury has proposed to treat a captive as an insurance company and its insurance as true "insurance" if 50 percent or less of the captive's premiums are attributable to "large-shareholder risks." A large shareholder would be defined as a 10-percent or greater shareholder.

H. Third-Party Ownership of Captives

1. In Rev. Rul. 78-338, 1978-2 C.B. 107, the IRS ruled that there is "insurance" when there are 31 insured shareholders, none of whose coverage exceeds 5 percent of the total. See also Rev. Rul. 80-120, 1980-1 C.B. 41.
2. Rev. Rul. 2002-91, 2002-52 I.R.B. 991, involves an industry captive situation under which a small number (i.e., at least 7) of unrelated businesses form a group captive, GC, that provides liability insurance to members only. No GC member owns more than 15% of GC or possesses more than 15% of the voting rights in GC, and no member's insured risk exceeds 15% of the total risk borne by GC. The ruling holds that (1) the arrangement between GC and its members constitutes "insurance" for tax purposes, (2) insurance premiums paid by GC's members are deductible as "insurance premiums" under section 162, and (3) GC will be taxable as an "insurance company" under section 831.

I. Subpart F Income ("Offshore Captives")

1. If the captive insurer is a foreign corporation, the Subpart F rules may apply.
2. Under Subpart F, certain income of a "controlled foreign corporation" (CFC) is taxable to its "U.S. shareholders." Section 951.
3. Generally, one method of avoiding the scope of Subpart F is to ensure that the CFC is widely-held.
4. However, the 1986 Act greatly expanded the reach of Subpart F, reducing the ownership requirements and providing that the

income of widely-held offshore captives may be currently taxable to their shareholders. Section 953(c).

5. The 1988 TAMRA enacted section 953(d), which allows foreign captives to elect to be taxed as domestic corporations.

J. Excise Tax on Premiums

1. Section 4371 imposes an excise tax on insurance premiums paid to foreign insurers and reinsurers.
2. However, this excise tax may be waived by tax treaty for captives located in certain countries. See, e.g., LTR 9629021 (Apr. 23, 1996)(U.S.-Sweden income tax treaty applied); LTR 9623009 (Feb. 29, 1996) (U.S.-Spain income tax treaty applied); LTR 9618024 (Feb. 5, 1996)(U.S.-Germany tax treaty applied).
3. In U.S. v. I.B.M., 517 U.S. 843 (1996), the Supreme Court held that the section 4371(1) excise tax cannot be constitutionally applied to goods in transit. The I.B.M. decision led to many excise tax refunds. See IRS Notice 96-37, 1996-2 C.B. 208.

III. Other Alternatives to Commercial Insurance

A. Funded Agreements to Share Liability

1. Pooled Self-Insurance Funds
 - a. Employers that self-insure their workmen's compensation liability may pool their liabilities. "Premiums" are paid into a fund, which is managed by a trustee.
 - b. The IRS has ruled that such funds are taxable as mutual P&C insurance companies. E.g., LTR 8405034 (Oct. 31, 1983).
 - c. The 1986 Act imposed a moratorium on audits of such funds. 1986 Act section 1879(q). The 1988 Act provided additional relief for years beginning before 1987. TAMRA Section 6076.
2. Risk Retention Groups
 - a. Under the Product Liability Risk Retention Act of 1981, 15 U.S.C. sections 3901-04, product sellers may form "risk retention groups" to pool their risk of exposure to liability.

- b. The Act grants risk retention groups a limited exemption from duplicative and overlapping state regulation.
- c. As enacted in 1981, the Act applied only to product liability. E.g., Home Warranty Corp. v. Elliott, 585 F. Supp. 443 (D. Del. 1984). In 1986, it was expanded to cover all types of liability insurance.
- d. Such a group would be taxable, most likely as a P&C insurance company.

B. Unfunded Agreements to Share Liability

- 1. Another alternative is to structure an arrangement that does not involve the formation of any new taxable entity. The parties to the agreement simply agree to pay portions of a loss suffered by any member, when such a loss occurs.
- 2. The payments should be deductible by the payors, and includible in the income of the recipient, in the year in which the third party claims are settled. See LTR 8032087 (May 15, 1980).