Captive Insurance Companies: Current Lay of the Land

Fred Thomas, Deloitte Tax
Natasha Ng, Deloitte Tax
Background

What is a captive insurance company?

• In general, a captive insurance company is an insurance company organized by one or more individuals or entities for the primary purpose of insuring the risks of related or affiliates businesses

• The IRS defines a captive insurance company as a “wholly owned insurance subsidiary”
Background

Reasons for Using a Captive Insurance Company

• Lower insurance costs
• Cash flow
• Risk retention
• Unavailability of coverage
• Risk management
• Reinsurance market
• Potential tax benefits
Background

Common Types of Captive Insurance Companies

• Single-parent captive insurance companies
• Association captives
• Group captives
• Agency captives
• Rent-a-captive
• Protected cell captives
Federal Characteristics of Insurance Companies

• In order for a captive insurance company to realize the federal tax benefits associated with insurance companies, it must show that it is a valid insurance company

• In addition to obtaining an insurance license from a state, the captive must provide insurance. The term “insurance” has not been defined by the Internal Revenue Code or the Treasury Regulations

• However, the Supreme Court has stated that “historically and commonly insurance involves risk-shifting and risk-distributing” (*Helvering v. Le Gierse*, 312 U.S. 531 (1941))

• In sum, a valid insurance arrangement requires the following:
  - An insurance risk
  - Risk shifting
  - Risk distribution
  - Commonly accepted notions of insurance
Federal Characteristics of Insurance Companies

• Risk Shifting
  ➢ Requires that the risk involved be transferred from the insured to the captive

• Risk Distribution
  ➢ Requires that enough premiums be pooled from enough risk such that the law of averages will result in actual losses approximating the projected losses

• Commonly Accepted Notions of Insurance
  ➢ Should have the “look and feel” of insurance: reasonable capitalization, reasonable premiums, standard policy forms, reasonable reserves, standard investments, corporate formalities maintained, independent operation, and reasonable regulation
State Characteristics of Insurance Companies

• State Regulation
  ➢ Insurance companies are regulated by state or foreign jurisdictions. For state purposes, insurance companies fall under the jurisdiction of a relevant state agency (generally, the Department of Insurance)

• California:
  ➢ See Legal Ruling 385
Tax Benefits of Captives

Potential Federal Benefits and Considerations

• Deductions for premiums paid by the parent company under IRC Section 162

• Potential for distributions to captive insurance owners at favorable income tax rates (i.e., dividends received deduction for parent company if captive is domiciled in the United States)

  ➢ Insurance companies must be taxed as a C corporation even if established as an LLC or a partnership

• Traditional captive insurance companies are taxed on premium income, but are provided a deduction for the actuarially determined reserve requirements it must meet

• IRC Section 831(b) election for “mini-captives”

• Gift and estate tax savings for shareholders
Tax Benefits of Captives

Potential State Benefits and Considerations

• Deductions for premiums paid
• May potentially avoid income tax-related give-back, “haircut,” or addback of the premiums paid (and deducted) by the payor
• Nearly all states do not subject an insurance company to a corporate income tax; therefore, non-premium earnings are generally not taxed for state corporate income tax purposes
• Premiums received are generally taxed at a more favorable rate than most other state income
• Premium tax is generally based on the location of the risk covered
• Many states carve out insurance companies from the state consolidated or combined filing group
• State dividends received deduction for dividends received from captive insurance companies
• Non-admitted insurers tax
State Rules Pertaining to Insurance Companies: California

- Article XIII, Section 28 – “In Lieu Provision”
- Franchise Tax Board Ruling 385
- Dividends Received Deduction under Cal. Rev. & Tax Code Section 24410
  - Prior to reformation due to *Ceridian*
  - *Ceridian, Farmer Bros., and Cutler* decisions
- *Myers v. State Board of Equalization*
- Cal. Rev. & Tax Code Section 24465
Limitations on Captives

Federal Activity

- Captives were viewed unfavorably by the IRS for many years
  - Rev. Ruling 77-316 – IRS announced that captive insurance arrangements would not be respected, no matter how they were structured
  - Prior to the *Humana* decision (decided in 1989), the IRS won most of the cases in the captive litigation area
Limitations on Captives

Federal Activity

• *Humana v. Comm’r*, 881 F.2d 247
  - Taxpayer was able to deduct premiums it paid on behalf of “brother-sister” affiliates

• *Ocean Drilling & Exploration Co. v. U.S.*, 988 F.2d 1135 (Fed. Cir. 1993); *Amerco v. Comm’r*, 979 F.2d 162 (9th Cir. 1992); *Sears, Roebuck and Co. v. Comm’r*, 972 F.2d 858 (7th Cir. 1992); *Harper Group v. Comm’r*, 979 F.2d 1341 (9th Cir. 1992)
  - Taxpayers were able to deduct premiums it paid because the captive insurance company insured a sufficient amount of unrelated business.

• Rev. Ruling 2001-31 – IRS officially announced that it would no longer be following Rev. Ruling 77-316, but would be evaluating captives on a case-by-case basis.
Limitations on Captives

Federal Activity

• Recent IRS guidance on the types of captives that will be respected (i.e., safe harbors)
  
  ➢ Rev. Ruling 2002-89 – captive must derive 50% of its revenue and risk from a non-parent
  
  ➢ Rev. Ruling 2002-90 – captive must underwrite risk for at least 12 different subsidiaries, none of which may comprise less than 5% nor more than 15% of the total risk underwritten by the captives
  
  ➢ Rev. Ruling 2002-91 – a captive group formed by a relatively small group of unrelated businesses involved in a highly concentrated industry to provide insurance coverage is an insurance company within the meaning of IRC Section 831
Limitations on Captives

Federal Activity

• Common Federal Controversy Areas Pertaining to Captives
  ➢ Excessive premiums
  ➢ Tax shelter practices in connection with small IRC Section 831(b) captive insurance companies
  ➢ Whether the company is issuing insurance
    ▪ Focus: Risk shifting and risk distribution requirements

• Expansion of Subpart F Income Rules by Legislature
  ➢ Pertains to foreign captives
Limitations on Captives

State Activity

• Common State Controversy Areas Pertaining to Captives
  ➢ Whether the company is issuing insurance
    ▪ Focus: Risk shifting and risk distribution requirements
  ➢ Business purpose of the insurance company
  ➢ Stiffer penalty regime (e.g., California Noneconomic Substance Transaction Underpayment Penalty)

• State Legislation Aimed Towards Captives
  ➢ Illinois privilege tax – 35 ILCS 5/304
  ➢ New York excludes overcapitalized captives from definition of an insurance company – N.Y. Tax Law § 211
  ➢ South Carolina imposes direct tax on captives – S.C. Code Ann. § 38-90-20
Limitations on Captives

State Activity – California Considerations

- Cal. Rev. & Tax Code Section 24465
  - M&A Related Transactions
    - Pre-approvals needed
    - Inapplicability of tax-free treatment
    - Deemed Distributions
  - California Penalties
    - Noneconomic Substance Transaction Penalty
    - Large Corporate Underpayment Penalty
    - Listed Transactions
What Does the Future Hold for Captives?

**State Considerations**

- Increased scrutiny on captive insurance companies
  - Focus on business purpose, especially if assets are moved into the captive
- Enforcement of state penalty regimes
- Taxpayer must devote more time and resources to navigate through the complexity of state law changes (e.g. finalization of the regulation under Cal. Rev. & Tax Code § 22465)
- Impact of current litigation (e.g., *Myers v. State Board of Equalization*) and potential that states will begin relying less on whether an insurance company is regulated by a state agency
Questions?
Contact Information

Fred Thomas
Tax Senior Manager, Los Angeles
+1 213 593 3741
frethomas@deloitte.com

Natasha Ng
Tax Manager, San Francisco
+1 415 783 5251
natng@deloitte.com
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