TECHNICAL MEMORANDUM

Captive Insurance Companies

By: Jeffrey I. Bleiweis

September 7, 2010

RMC GROUP

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TECHNICAL MEMORANDUM

TO: Raymond G. Ankner, President

FROM: Jeffrey I. Bleiweis, Vice President and General Counsel

RE: Captive Insurance Companies

DATE: September 7, 2010

INTRODUCTION

While not new, the captive insurance company has gained popularity within the past decade as a planning tool for small, closely-held businesses. This new popularity is the result of two factors. First, as operating a small business has become more complex and expensive, owners are searching for ways to better manage risk and reduce expenses. A captive insurance company gives a business greater control over its insurance needs and allows it to reduce premiums paid to third-party insurers. Second, the law governing captive insurance companies has been made clearer and more favorable through legislation passed by Congress and guidance issued by the Internal Revenue Service (IRS).

The purpose of this Memorandum is to assist a business owner in his review of the concept of the captive insurance company. It will discuss exactly what the term "captive insurance company" means, the law governing the establishment and management of a captive insurance company and some of the reasons why a small business might want to create a captive insurance company. This Memorandum is not to be read as a legal opinion, but may be used as a resource. Whether a captive insurance company is appropriate for a particular business depends upon the facts and circumstances of that business. In addition, whether a particular captive insurance company is operated in accordance with the law depends upon the facts and circumstances of the captive. However, this Memorandum will provide an understanding of some of the issues faced by a business seeking to establish a captive insurance company.

Furthermore, because I am Vice President and General Counsel of RMC and am involved in the design and marketing of RMC's captive insurance program, no person or entity contemplating the creation of a captive insurance company may consider this discussion "legal advice". It is likely that this Memorandum would be considered a "marketed opinion" under section 10.35 of Circular 230, which governs practice before the IRS, because it has been written for the purpose of supporting the marketing of RMC's captive insurance program. As a result, no person or entity may use this letter to justify the tax treatment of the premiums paid to its captive insurance company, the tax treatment of its captive insurance company, or to avoid penalties or interest. While this Memorandum expresses my honest opinion about the issues discussed herein as they relate to RMC's captive insurance program, no representation can be made about how the IRS will treat the captive insurance company of any particular business in the event that such business undergoes an IRS audit. Each person or entity contemplating the establishment of a captive insurance company should consult with and rely upon independent tax and legal advisors.

WHAT IS A CAPTIVE INSURANCE COMPANY?

A captive insurance company can take many forms. However, in simple terms, a captive insurance company is a company formed to provide property and casualty insurance to its parent or to a group of affiliated companies. A captive insurance company is a corporation, separate and apart from its owner. It can be formed off-shore or domestically. However, wherever it is formed, it will be required to comply with the corporation laws of its domicile jurisdiction. In addition, because it is an insurance company, it will be subject to regulation by the department of insurance of its domicile jurisdiction, including, but not limited to, that jurisdiction's capital and surplus requirements.

For purposes of understanding what a captive insurance company is, there are two common structures that the entity might take. The first is the parent-subsidiary captive. In this structure, the captive is owned, either directly or indirectly, by the business to which the captive provides insurance. To illustrate this structure, the ABC Company creates the ABC Property & Casualty Insurance Company to provide insurance coverage to the ABC Company.

The second structure is the brother-sister captive. In this structure, the captive insures the risks of affiliated companies, all of which, including the captive, are owned, either directly or indirectly, by a common parent. To illustrate this structure, the ABC Company owns a number of subsidiaries. It forms the ABC Property & Casualty Insurance Company, as a wholly-owned subsidiary, to provide insurance coverage to its other subsidiaries.

There are many reasons why a business might form a captive insurance company. However, a fundamental reason is to better manage insurance risks and to reduce insurance costs. A benefit of forming a captive insurance company is that insurance premiums are generally deductible from income. Section 162(a) of the Internal Revenue Code (the "Code") provides that:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .

In addition, section 1.162-1(a) of the treasury regulations provides that:

> Among the items included in business expenses are . . . insurance premiums against fire, storm, theft, accident, or similar losses in the case of a business . . .

As a result, a business can deduct payments made to an insurance company, which it owns and controls, as long as those payments constitute insurance premiums under the Code and constitute ordinary and necessary business expenses.

WHAT IS AN INSURANCE PREMIUM?

Like many areas in the Code, the answer to this question is somewhat circular. An insurance premium is a payment to an insurance company in exchange for an insurance contract. An insurance contract is a written agreement by an insurance company to provide insurance. An insurance company is a company that issues insurance contracts.

> The term "insurance company" means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the

> business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code. [Treas. Reg. 1.801-3(a)(1)]

The foregoing is not very helpful; with the exception, however, that we can be pretty sure that the common denominator in the definitions of "insurance premium", "insurance contract" and "insurance company" is "insurance". If we can define the term "insurance", then we will be able to define the terms "insurance premium", "insurance contract" and "insurance company". Unfortunately, the term "insurance" is not defined in the Code.

The definition of "insurance" has developed through case law, mostly in cases brought by taxpayers challenging the denial of deductions taken for payments to a purported captive; although, as discussed below, the most cited case in this area did not involve a captive. In all such cases, the IRS denied the deduction claiming that the arrangement did not constitute "insurance", and, as a result, the payments made to the purported captive were not "insurance premiums".

The seminal case in this area is Helvering v. Le Gierse 312 U.S. 531 (1941), a case in which a decedent purchased a life insurance policy and an annuity contract from the same insurance company one month before her death. The insurance company would not have issued the life insurance policy without the annuity contract, and the aggregate premiums for the insurance policy and the annuity contract exceeded the face amount of the insurance policy. When the decedent died, her executor sought to exclude the insurance proceeds from her estate under the predecessor to section 101(a) of the Code. However, the IRS claimed that the arrangement was not insurance, that the payment from the insurance company was not insurance proceeds and that the payment was includible in income.

The case made its way to the Supreme Court, and the Court sustained the IRS and held that the arrangement did not constitute insurance, because the insurance company assumed no risk.

> We think . . . that the amounts (premiums) must be received as the result of a transaction which involved an actual 'insurance risk' at the time the transaction was executed. Historically and commonly insurance involves risk-shifting and risk-distributing.
>
> Considered together, the contracts wholly fail to spell out any element of insurance risk. It is true that the 'insurance' contract looks like an insurance policy, contains all the usual

> provisions of one, and could have been assigned or surrendered without the annuity . . . (However,) the total consideration was prepaid and exceeded the face value of the insurance policy. The excess financed loading and other incidental charges. Any risk that the prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk . . .

While the Court in Le Gierse defined insurance as having the elements of risk-shifting and risk-distributing, it did not define either element. That task was left to other courts in other cases. A good example of those cases is the oft-cited case, Clougherty Packing Company v. Commissioner 811 F.2nd 1297 (9th Cir. 1987). In that case, the taxpayer obtained workers' compensation insurance from an unrelated insurance company. That company, however, then reinsured its risk with a captive insurance company owned by the taxpayer. The taxpayer deducted the payments made to the unrelated insurance company, and the IRS denied the deduction.

In deciding the issue, the Court first acknowledged that insurance premiums are deductible expenses.

> Premiums for insurance, including those for workers' compensation coverage, are deductible business expenses. 26 C.F.R. section 1.162-1(a) (1986).

The Court then contrasted the taxpayer who buys insurance with the taxpayer who self-insures the risk and has to wait until losses actually occur before taking a deduction.

> In lieu of purchasing insurance, one may elect to self-insure, paying off claims as they arise or setting aside fixed sums into a reserve account to pay off intermittent losses. While insurance premiums are deductible, amounts placed into self-insurance reserves are not.

The Court then said that the issue in this case is whether the taxpayer's payments, which ultimately ended up with its captive, are more like insurance premiums or more like deposits into a self-insurance reserve.

The Court cited the Le Gierse case and said that, although insurance is not defined in the Code, it is generally accepted that insurance requires risk-shifting and risk-distributing. It then went on to define these terms:

> Shifting risk entails the transfer of the impact of a potential loss from the insured to the insurer. If the insured has shifted its risk to the insurer, then a loss by or a claim against the insured does not affect it because the loss is offset by the proceeds of an insurance payment.
>
> Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. (citations) Risk distribution incorporates the statistical phenomenon known as the law of large numbers.

The Court further said that risk-shifting looks at the arrangement from the perspective of the insured, while risk-distributing looks at the arrangement from the perspective of the company.

Finally, the Court held that this arrangement did not constitute insurance, because there was no shifting of the risk. While any workers' compensation claim against the taxpayer would be paid by the unrelated insurance company, that company would be reimbursed by the captive insurance company owned by the taxpayer. As a result, the risk did not really shift from the taxpayer to the unrelated insurance company, but stayed on the taxpayer's books. Because the claim would ultimately be paid from the taxpayer's assets, the economic substance of the arrangement was more like a reserve established to fund future losses and not deductible.

The problem with the Court's decision in Clougherty is that the Court ignored the fact that the taxpayer and its captive were separate and distinct entities with a separate and distinct financial existence. In this regard, the Court, while not expressly adopting the doctrine, was certainly influenced by the position set forth by the IRS in Rev. Rul. 77-316. In that revenue ruling, the IRS enunciated what is commonly referred to as the "economic family doctrine".

WHAT IS THE ECONOMIC FAMILY DOCTRINE?

In 1977, the IRS sought to limit the utility of captive insurance companies by issuing Rev. Rul. 77-316, which described three fact situations. In situation 1, the taxpayer and its subsidiaries obtained fire and other casualty insurance from a wholly-owned subsidiary of the taxpayer. The captive insured the risks of no other entities. The facts of situation 2 were the same as situation 1, except that the taxpayer and its subsidiaries obtained insurance from an unrelated insurance company, and the unrelated insurance company reinsured 95% of the total risk to a wholly-owned subsidiary of the taxpayer. In situation 3, the taxpayer and its subsidiaries obtained insurance from another wholly-owned subsidiary of the taxpayer, but the captive then reinsured 90% of the total risk to the unrelated insurance company.

The IRS held that none of the situations described in the revenue ruling constituted insurance, and, as a result, payments made by the taxpayer and its subsidiaries were not deductible as insurance premiums; with the exception, however, of risks actually retained by the unrelated insurance company – 5% in situation 2 and 90% in situation 3.

> Under the three situations described, there is no economic shifting or distributing of risks of loss with respect to the risks carried or retained by the wholly owned foreign subsidiaries . . . In each situation described, the insuring parent corporation and its domestic subsidiaries, and the wholly owned "insurance" subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss. To the extent that the risks of loss are not retained in their entirety by (as in Situation 2) or reinsured with (as in Situation 3) insurance companies that are unrelated to the economic family of insureds, there is no risk-shifting or risk-distributing, and no insurance, the premiums for which are deductible under section 162 of the Code.

Thus was borne the economic family doctrine, which, if followed to its logical conclusion, would have prevented most small businesses from using a captive insurance company. However, while the reasoning of the Clougherty opinion is arguably indistinguishable from the economic family doctrine, no court expressly accepted or applied the economic family doctrine after it was enunciated by the IRS in Rev. Rul. 77-316. This does not mean that the IRS was unsuccessful in its challenges to the captive insurance company technique. For a substantial period of time, most cases ended in victory for the IRS.

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THE TIDE BEGINS TO TURN

In Rev. Rul. 78-338, the IRS provided an exception to the economic family doctrine. In that revenue ruling, the IRS described a situation where 31 unrelated taxpayers owned a foreign insurance company, which provided insurance only to its owners. No insured owned a controlling interest in the captive, and no insured represented more than 5% of the total risk assumed by the captive.

The IRS held that an arrangement as described in the revenue ruling does constitute insurance because the insureds are not related.

> Here, because the taxpayer and the other insureds-shareholders are not economically related, the economic risk of loss can be shifted and distributed among the shareholders who comprise the insured group.
>
> Accordingly, in the instant situation, because the requisite risk-shifting and risk-distribution necessary to constitute insurance are present, it is held that the amount paid by the taxpayer for this insurance are premiums deductible as ordinary and necessary business expenses under section 162 of the Code, provided they are reasonable in amount for the insurance coverage obtained and provided they are based on sound actuarial principles.

In the late 1980's and early 1990's, the IRS began to lose cases in court. In Humana, Inc. v. Commissioner 881 F.2nd 247 (6th Cir. 1989), the Court both ruled for and against the IRS. In Humana, the taxpayer had created a foreign captive insurance company to provide insurance to itself and its subsidiaries. The IRS disallowed the taxpayer's deductions, and the taxpayer appealed.

First, the Court restated the definition of insurance.

> An insurance contract involves (1) risk shifting and (2) risk distribution. Helvering v. Le Gierse 312 U.S. 539 (1943) . . . Risk shifting involves the shifting of an identifiable risk of the insured to the insurer. The focus is on the individual contract between the insured and the insurer. Risk distribution involves shifting to a group of individuals the identified risk of the insured. The focus is broader and looks more to the insurer as to whether the risk insured against can be distributed over a large group rather than the relationship

> between the insurer and any single insured.

Then, the Court sustained the determination of the IRS with respect to premiums paid by the parent, but reversed the IRS with respect to premiums paid by the subsidiaries. The Court determined that there is no risk shifting between the taxpayer and its captive insurance company.

> If the parent suffers an insured loss which the captive has to pay, the assets of the captive will be depleted by the amount of the payment. This will reduce the value of the captive's shares as an asset of the parent. In effect, the assets of the parent bear the true economic impact of the loss.

However, the Court determined that there is risk shifting between the taxpayer's subsidiaries and the captive.

> The economic reality, however, of insurance between the Humana subsidiaries and Health Care Indemnity, where the subsidiaries own no stock in the captive and vice versa, is that when a loss occurs and is paid by Health Care Indemnity the net worth of the Human affiliates is not reduced accordingly. The subsidiaries' balance sheets and net worth are not affected by the payment of an insured claim by Health Care Indemnity. In reality, therefore, when the Humana subsidiaries pay their own premiums under their insurance contracts, as the facts show, they shift their risk to Health Care Indemnity.

In addition, the Court held that, while there may be no risk distribution between a parent and a captive, there is risk distribution when subsidiaries purchase insurance from the captive.

> An arrangement between a parent corporation and a captive insurance company in which the captive insures only the risks of the parent might not result in risk distribution. Any loss by the parent is not subject to the premiums of any other entity. However, we see no reason why there would not be risk distribution in the instant case where the captive insures several separate corporations within an affiliated group and losses can be spread among the several distinct corporate entities.

The IRS lost again in The Harper Group v. Commissioner 96 T.C 45 (1991), affirmed at 979 F.2d 1341 (9^{th} Cir. 1992). In Harper, the taxpayer had formed a foreign captive insurance company to provide insurance to itself and its subsidiaries. However, unlike the Humana case, Harper's captive also provided insurance to unrelated entities. During the tax years in question, the amount of insurance provided to unrelated entities ranged from 29% to 33% of the total risk assumed by the captive.

The Court reversed the determination of the IRS and held that, under the circumstances of this case, the premiums paid by both the parent and the subsidiaries are deductible as insurance premiums. First, the Court killed the economic family doctrine.

> We have repeatedly rejected respondent's economic family theory.

The Court then said that, whether an insurance arrangement exists, depends upon "the facts and circumstances of the particular case". The Court also "rejected the proposition (from a tax viewpoint) . . . that a parent corporation can never obtain insurance from an insurance company subsidiary". Finally, the Court set forth a 3-prong test to determine whether an arrangement constitutes insurance.

(1) whether the arrangement involves the existence of an insurance risk;

(2) whether there was both risk-shifting and risk-distribution; and

(3) whether the arrangement was for insurance in its commonly accepted sense.

The Court found that the arrangement in Harper involved an insurance risk. Harper and its subsidiaries were engaged in the air transport business. They each faced substantial liability if an item accepted for transport was damaged or lost. Therefore, an insurance risk existed.

The Court also found that there was risk-shifting and risk-distribution.

> Here, risk-shifting occurred – insurance contracts were written, and premiums, as well as claims for losses, were paid. Rampart was a corporation whose existence was separate from that of Harper, CAC and Harper Robinson. Rampart was not a sham; it conducted a bona fide insurance business and was regulated as an insurance company under the laws of Hong Kong . . . Rampart was not only financially capable of satisfying claims made against it, but it in fact paid such claims.

> Here, risk distribution also occurred . . . the relatively large number of unrelated insureds comprise approximately 30 percent of Rampart's business; such a level of unrelated insureds, in our opinion, constitutes a sufficient pool of insureds to provide risk distribution.

Finally, the Court found that the arrangement was insurance as that term is commonly understood.

> Ramparts was both organized and operated as an insurance company. It was regulated by the Insurance Registry of Hong Kong. The adequacy of Rampart's capitalization is not in dispute . . . The policies issued by Rampart were valid and binding. In sum, such policies were insurance policies, and the arrangements between the Harper domestic subsidiaries and Rampart constituted insurance, in the commonly accepted sense.

Perhaps because of its losses in court, in 2001, the IRS officially withdrew the economic family doctrine. In Rev. Rul. 2001-31, the IRS acknowledged that:

> No court, in addressing a captive insurance transaction, has fully accepted the economic family theory set forth in Rev. Rul. 77-316. Accordingly, the Internal Revenue Service will no longer invoke the economic family theory with respect to captive insurance transactions.

The IRS did say that it "may, however, continue to challenge certain captive insurance transactions based on the facts and circumstances of each case".

SAFE HARBORS

In the first paragraph of this Memorandum, I said that "the law governing captive insurance companies has been made clearer and more favorable through . . . guidance issued by the Internal Revenue Service". This is because, beginning in 2002, the IRS released a series of revenue rulings that seemed to clarify its position regarding captive insurance companies. These revenue rulings have created a "safe harbor". This means that, in setting up its captive, a taxpayer can have a reasonable expectation that the IRS will recognize the arrangement as insurance, as long as the taxpayer follows the rules set forth in the revenue rulings.

In Rev. Rul. 2002-89, the IRS described two fact situations. In each fact situation, the taxpayer created a wholly-owned captive insurance company. The captive was organized and operated as an insurance company in accordance with the laws of its domicile jurisdiction. The risks assumed by the captive constituted legitimate insurance risks, and the premiums paid by the taxpayer were reasonable and customary. In situation 1, 90% of the premiums received by the captive came from the taxpayer. In situation 2, less than 50% of the premiums received by the captive came from the taxpayer.

The IRS held that situation 1 is not insurance for federal tax purposes, but situation 2 does constitute insurance.

> No court has held that a transaction between a parent and its wholly-owned subsidiary satisfies the requirements of risk shifting and risk distribution if only the risks of the parent are "insured". However, courts have held that an arrangement between a parent and its subsidiary can constitute insurance because the parent's premiums are pooled with those of unrelated parties if (i) insurance risk is present, (ii) risk is shifted and distributed, and (iii) the transaction is of the type that is insurance in the commonly accepted sense.

Because the taxpayer accounts for 90% of the premiums paid to the captive in situation 1, the arrangement lacks risk-shifting and risk-distribution. However, where the parent accounts for less than 50% of the premiums paid to the captive, the requisite risk-shifting and risk-distribution are present.

Rev. Rul. 2002-89 is generally understood to provide a safe harbor for parent-subsidiary captive insurance arrangements. As long as the parent represents less than 50% of the premiums paid to the captive and less than 50% of the total risk assumed by the captive, the arrangement will constitute insurance for federal tax purposes, and the owner's premiums may be deductible, if they otherwise qualify under section 162(a) of the Code.

In Rev. Rul. 2002-90, the IRS provided rules for a brother-sister arrangement. In the revenue ruling, the IRS discussed the situation where the taxpayer owned 12 subsidiaries, each of which was separately engaged in business. The taxpayer formed a wholly-owned captive insurance company for the benefit of its other subsidiaries. Each subsidiary paid premiums to the captive. No subsidiary represented less than 5% or more than 15% of the aggregate premiums paid to the captive or the total risk assumed by the captive. The IRS held that this arrangement constituted insurance and that the premiums paid by the subsidiaries were deductible expenses under section 162(a) of the Code.

> In the present case, the professional liability risks of 12 operating subsidiaries are shifted to S. Further, the premiums of the operating subsidiaries, determined at arms-length, are pooled such that a loss by one operating subsidiary is borne, in substantial part, by the premiums paid by others . . . The narrow question presented is whether (the taxpayer's) common ownership of the operating subsidiaries and (the captive) affects the conclusion that the arrangements at issue are insurance for federal tax purposes. Under the facts presented, we conclude the arrangements between (the captive) and each of the 12 operating subsidiaries of (the captive's) parent constitute insurance for federal income tax purposes.

Rev. Rul. 2002-90 sets forth the safe harbor for brother-sister arrangements. As long as a taxpayer has at least 12 subsidiaries, a captive insurance company, owned directly or indirectly by the taxpayer and formed for the purpose of insuring the risks of its subsidiaries, should constitute insurance, and the premiums paid by the subsidiaries to the captive should be deductible, as long as they otherwise qualify under section 162(a) of the Code.

In Rev. Rul. 2002-91, the IRS revisited the issue raised in Rev. Rul. 78-338. In that revenue ruling, the IRS had said that a captive owned by 31 unrelated entities could constitute an insurance arrangement. In Rev. Rul. 2002-91, the IRS discussed a group captive owned by fewer than 31 unrelated entities. The IRS did not provide the number of owners of the group captive, but simply said that no insured owns less than 5% or more than 15% of the captive, and no insured represents less than 5% or more than 15% of the total risk assumed by the captive.

The IRS reviewed the factors to be considered in determining whether an arrangement constitutes insurance.

> Additional factors to be considered in determining whether a captive insurance transaction is insurance include: whether the parties that insured with the captive truly face hazards; whether premiums charged by the captive are based on commercial rates; whether the validity of claims was established before payments are made; and whether the captive's business operations and assets are kept separate from the business

operations and assets of its shareholders.

The IRS then held that the fact situation described in the revenue ruling constitutes insurance.

> X and the other Members face true insurable hazards . . . Notwithstanding the fact that the group of Members is small, there is a real possibility that a Member will sustain a loss in excess of the premiums it paid. No individual Member will be reimbursed for premiums paid in excess of losses sustained by that Member. Finally, X and the other Members are unrelated. Therefore, the contracts issued by GC to X and the other Members are insurance contracts for federal income tax purposes, and the premiums paid by the Members are deductible under section 162.

The holding of Rev. Rul. 2002-91 provides a strategy for a business that may not be in a position to form its own captive. By joining with other businesses in its industry, it can form a group captive, thereby spreading the administrative costs over a larger number of entities, as well as providing the risk distribution that is required, while still maintaining the ability to manage the risks assumed. Rev. Rul. 2002-91 does not state the number of entities required to form a group captive. However, given the requirement that no entity own more than 15% of the captive or represent more than 15% of the total risk assumed by the captive, it is generally assumed that the IRS would find that a group captive owned by as few as 8 businesses could constitute an insurance arrangement for tax purposes.

In Rev. Rul. 2008-8, the IRS discussed the concept of the "protected cell company". A "protected cell company" is a creature of the laws of a particular jurisdiction. It is a structure whereby a sponsor forms a captive insurance company, which is then permitted to create separate subaccounts or cells under the captive. Each cell is associated with a particular insured, which may or may not be related to the other insureds. Not all jurisdictions allow for protected cell companies.

The captive is considered to be the insurance company under the law of its domicile jurisdiction, and the sponsor is responsible for complying with the insurance regulations of its domicile, at the captive level, including capital and surplus requirements. The sponsor owns all of the common stock of the captive. The assets and liabilities of the captive, as well as each cell, are segregated, and neither the captive, nor any other cell, is liable for the risks assumed by a particular cell. A participant pays premiums to its cell.

The protected cell company was devised as a means to get around the risk-shifting and risk-distribution requirements of Rev. Rul. 2002-89. It was thought that, even though each cell operates like a parent-subsidiary captive, in that each cell only assumes the risks of the entity associated with it, the arrangement could be treated as a brother-sister captive, by treating the captive as an affiliate of the cells. The problem with this argument is that the captive is not liable for the risks assumed by the cells, and the assets of the captive are shielded from the liabilities of the cells. As a result, the risks associated with a particular cell are not shifted to the captive, nor are they distributed among the other cells.

In Rev. Rul. 2008-8, the IRS said that, in a protected cell arrangement, each cell will be treated as a separate insurance company. As a result, each cell would separately have to satisfy the risk-shifting and risk-distribution elements of insurance, whether those defined in Rev. Rul. 2002-89 for parent-subsidiary arrangements or in Rev. Rul. 2002-90 for brother-sister arrangements.

HOW IS A CAPTIVE INSURANCE COMPANY TAXED?

Most captive insurance companies are formed as property and casualty companies. Since the capital and surplus requirements for a property and casualty company are significantly less than the requirements for a life insurance company, it is easier for a small business to form a property and casualty captive insurance company.

The tax on property and casualty insurance companies is set forth in section 831(a) of the Code.

> Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company.

When section 831(a) says that taxes are computed as provided in section 11, it is referring to the corporate income tax. This means that a captive insurance company is taxed as a c-corporation. Furthermore, the term "taxable income", which is defined in section 953(a) of the Code, includes premiums received by the captive for insurance contracts. However, Congress has provided an alternate method of taxation for small insurance companies. Section 831(b)(1) of the Code provides that:

> In lieu of the tax otherwise applicable under subsection (a), there is hereby imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company

for such taxable year by the rates provided in section 11(b).

The type of insurance company to which the foregoing applies is set forth in section 831(b)(2)(A).

> This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if –
>
> (i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $1,200,000, and
>
> (ii) such company elects the application of this subsection for such taxable year.

The result is that a captive insurance company that is able to file an election under section 831(b) is taxed on its investment income instead of its premium income.

WHAT IF A CAPTIVE IS FORMED OFF-SHORE?

The provisions of the Internal Revenue Code generally apply to citizens and residents of the United States or to income earned in connection with business conducted within the United States. If a captive insurance company is formed off-shore, it is not a citizen or resident of the United States. In addition, unless it is admitted in a State of the United States, it will not be authorized to conduct business within the United States. Does this mean that the income of a captive formed off-shore in a jurisdiction that does not have an income tax is never taxed? The answer is no.

In most cases, a captive insurance company will be a controlled foreign corporation under United States tax law. As applied to off-shore insurance companies, a controlled foreign corporation is a corporation organized under the laws of a foreign jurisdiction, at least 25% of the shares of which are owned by United States shareholders. [See section 953(d) of the Code.] Since the captive insurance company will be owned by a U.S. business or the owner of that business, the captive insurance company is a controlled foreign corporation.

It used to be that a U.S. taxpayer could shelter income earned by a foreign corporation by keeping that income off-shore. The U.S. taxpayer would not be taxed until the income of the foreign corporation was repatriated to the United States. That is no longer the law. Now, certain income of a controlled foreign corporation is taxed to the U.S. shareholders of the corporation in the year in which the income is earned, even if the income is not paid to the U.S. shareholders. The income of the controlled foreign corporation that is taxed to the U.S. shareholders is called "subpart F income". [See section 951(a) of the Code.] "Subpart F income" includes insurance premiums. [See section 952(a) of the Code.]

Does this mean that a U.S. owner of an off-shore captive insurance company will be taxed on the premium income paid to the captive? The answer is no, as long as the captive insurance company elects to be taxed as a U.S. corporation.

Section 953(d)(1) of the Code permits a foreign insurance company to be taxed as a United States corporation.

> If –
>
> (A) a foreign corporation is a controlled corporation . . . and
>
> (B) such foreign corporation would qualify under part I or II of subchapter L for the taxable year if it were a domestic corporation,
>
> (C) such foreign corporation meets the requirements as the Secretary shall prescribe . . . and
>
> (D) such foreign corporation makes an election to have this paragraph apply,
>
> for purposes of this title, such corporation shall be treated as a domestic corporation.

This means that a captive insurance company, formed off-shore, can avoid treatment as a controlled foreign corporation and obtain the benefits of section 831(b) of the Code by electing to be taxed as a domestic corporation.

SUMMARY

For many years, the captive insurance company was the exclusive planning tool of large corporations. In fact, many Fortune 500 companies have created captive insurance companies. For example, Allstate began life as a captive of Sears. Now, with the clarity provided by the IRS revenue rulings and the tax benefits of section 831(b), a captive insurance company makes as much sense for a small, closely-held business as for a large multi-national corporation.

A captive insurance company can be formed off-shore or domestically. Most off-shore jurisdictions have significantly lower capital and surplus requirements than any State of the United States. This means that forming a captive insurance company off-shore will be significantly less expensive than forming a captive under the laws of a State. However, it also means that the captive will be subject to regulation by the foreign jurisdiction, which may be less convenient for the captive owner. Wherever the captive is formed, it will be a separate entity from the captive owner and will be required to comply with the corporate laws of the jurisdiction where it is organized.

Most captive insurance companies will be formed as property and casualty companies. The capital and surplus requirements for a property and casualty insurance company are significantly less than the capital and surplus requirements for a life insurance company. In addition, property and casualty risks are easier to underwrite and manage.

Among the many reasons to form a captive insurance company is the ability to control the cost of insurance and to manage risk. By forming a captive insurance company, a business can pay insurance premiums to a company that it owns and controls, instead of paying such premiums to an unrelated third-party. A premium paid to an unrelated third-party insurer includes administrative expenses and profit. A business that pays premiums to its captive saves those dollars.

A captive insurance company can insure any legitimate risk faced by the captive owner in the operation of its business. This includes risks for which commercial insurance is available, but prohibitively expensive, as well as risks for which commercial insurance is not currently available. In addition, by forming a captive, a business may be able to realize savings by increasing the deductibles on existing policies. The types of risks that may be insured by a captive are unlimited and dependent upon the nature of the business in which the captive owner is engaged. However, the risks must be insurance risks and not merely business or investment risks.

A business that forms a captive is better able to manage risks. Since it is responsible for the operation of the insurance company, it will establish underwriting guidelines, set premiums and determine which risks to assume. To the extent that it is able to control claims and administrative expenses, the profits of the captive will inure to the benefit of the captive owner.

Because insurance premiums are deductible to the captive owner under section 162(a) of the Code and section 831(b) permits certain captives to avoid tax on the premiums paid by its owner, there is room for abuse. As a result, the IRS has provided "safe harbors" for captive insurance companies.

A parent-subsidiary arrangement is one where the captive is formed to provide insurance to its owner. The IRS safe harbor requires that, in order to constitute an insurance arrangement, the parent cannot represent more than fifty percent of the premiums paid to the captive or the risk assumed by the captive. This means that the captive must provide insurance to unrelated entities.

A brother-sister arrangement is one where the captive is formed to provide insurance to the other subsidiaries of a common parent. The IRS safe harbor says that an insurance arrangement exists where the captive is providing insurance to at least 12 subsidiaries of the common parent, as long as no subsidiary represents more than 15% of the total premiums paid to, or risks assumed by, the captive.

A variation on the brother-sister arrangement is the group captive. This is an arrangement where a number of entities engaged in the same type of business form a captive. This arrangement makes sense for businesses that do not have the financial resources to form a parent-subsidiary captive or the desire to assume risks from unrelated and unknown third-parties or do not have the requisite number of subsidiaries required by the brother-sister safe harbor. A group captive is owned by, and assumes the risks of, more than one business. The IRS has never provided a minimum number of owners required to constitute a group captive. However, because the IRS has said that no owner can own more than 15% of the shares of the captive, and no owner can represent more than 15% of the aggregate risks assumed by the captive, the IRS safe harbor for group captive is assumed to be at least 8 businesses.

A captive insurance company can be a powerful planning tool for the small, closely-held business. However, it must be done right!

RESOURCES

ABOUT THE AUTHOR

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Jeff joined CJA & Associates, a member of the RMC Group, in 1993 and currently serves as Vice President and General Counsel. He advises senior management on legal and tax issues related to the design and administration of insurance products, employee benefit plans, and risk management services.

Mr. Bleiweis frequently speaks before professional groups on the use of insurance products in qualified and non-qualified employee benefit plans. He has addressed meetings of accountants, financial planners, and insurance professionals across the country. He advises a nationwide network of independent insurance agents on tax and ERISA issues and has written extensively in the course of that work. He has published several articles on employee benefit plan issues. He has also testified before the Internal Revenue Service.

Mr. Bleiweis currently resides in Winnetka, Illinois, with his wife and two children.

ONLINE SUPPORT INFORMATION

Customers may access support information related to captive insurance on rmcgp.com/user

IMPORTANT KNOWLEDGE BASE ARTICLES

New knowledge base articles have been posted online to assist with captive insurance company questions, as well as other areas of interest, including:

- Pension Plans & Retirement Planning
- Insurance
- Self-Insurance
- Risk Management
- Employee Benefits
- Health & Welfare Plans

INFORMATION ON ADMINISTRATIVE & CONSULTING SERVICES

For more information about RMC Group's Administrative and Consulting Services, there are three easy ways to get in contact with us.

web: www.rmcgp.com/products-services

email: rmc@rmcgp.com

call: 888.599.5553

INDUSTRY RESOURCES & GENERAL GUIDELINES

For more industry information and general guidelines on captive insurance:

Captive Insurance Companies Association (CICA):
www.cicaworld.com/Resources.aspx

Self-Insurance Institute of America (SIIA):
www.siia.org/i4a/doclibrary/

The Risk Management Society (RIMS):
www.rims.org/resources/ERM/Pages/default.aspx

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