

CAPTIVE & INSURANCE BUSINESS TRANSFER  
CONFERENCE



OKLAHOMA CITY

# US Regulatory Realm and Hot Topics in Tax (Federal and State)

August 25, 2022  
Oklahoma City, Oklahoma

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# AGENDA

- Ask Questions as We Proceed
  
- Background and Current Developments
  - Insurance Regulatory
  - Federal Income Tax
  - State Income Tax
  - Delaware D&O Insurance Coverage
  - Employee Benefits in Captives
  - Washington State

# INSURANCE REGULATORY



## Captives: History and Domiciles

- 19th Century and earlier - Marine Voyages - Early captives shared risks among shippers on the same voyage and among different owners of different voyages (Lloyd's of London).
- 1920s - European Single-Owner Captives formed to respond to lack of coverage by commercial insurers. Example was British Petroleum's captive called "Tanker" which was used to insure shipping risks.
- 1953 - First "Captive" - Frederic M. Reiss (1924–1993), often called the father of the captive movement, founded Steel Insurance Company of America, a captive developed for an Ohio steel company, from which the term "captive" was borrowed from "captive" mines sending ore to the company's mills.

## Captives: History and Domiciles (cont.)

- 1958 - First Bermuda Captive - Fred Reiss set up American Risk Management in Bermuda, where the first captives were domiciled.
- 1976 - Cayman started as a healthcare captive center. Harvard Medical Center's captive met with "resistance" in Bermuda because of its need to cover individual physicians, so they moved to Cayman. Today, Cayman is the largest offshore domicile for healthcare organizations based in the United States.
- U.S. Domiciles – Colorado (1978); Tennessee (1978; 2011); Vermont (1981); Nevada (1999); South Carolina (2000); Montana (2001); Utah (2003); Delaware (2005); Connecticut (2008); North Carolina (2013); Oklahoma (2004; 2012)

## Self-Insurance vs. Captive Insurance

- Self-insurance is the payment of claims or losses directly by you at the time of a claim. No separate insurance company entity is formed or involved. This is on a **cash basis**.
- Captive Insurance Company is a separate incorporated entity that pre-funds losses and maintains reserves for known and unknown loss events. This is on an **accrual basis**.

# Captives: Regulatory Framework

## ➤ Three Main Regulators

- Insurance (State based)
  - Captives only licensed in one domiciliary state
- Securities (State and Federal)
  - Often overlooked, but must evaluate and meet state and federal securities exemptions
- Tax (State and IRS)
  - Premium tax is state income tax
  - Federal tax status as insurance company (IRS)

# Captives: Regulatory Framework (Types of Captives)

- Traditionally, hallmark of a captive was that insureds are owners; third party business now permitted on-shore in certain instances, usually as reinsurance
- Types of Captives:
  - Pure (single owner) insures risks of parent and affiliates, as well as controlled unaffiliated business
  - Group or Association insures group of similar businesses or members of trade association
  - Industrial Insured (rarely used now)
  - Branch (also not common)
  - Agency (third party)
  - Protected Cell / Segregated Portfolio Company
    - Incorporated (corporations, LLCs, and Series LLCs)
    - Unincorporated
    - Mix and match cells



# Captives: Regulatory Framework (Filings)

## ➤ Regulatory requirements include:

- Depository agreement for minimum capital
- Biographical affidavits for key owners, Board members, officers
- Annual report
- Annual premium payment
- Must designate service providers
- Audited financial statements
- Examination by Dept. (more frequent if no audited financials)
- Approval for material business plan changes, notification for non-material
- Approval for dividends
- Investment policy, ethics policy, annual conflict of interest forms

# Captives: Regulatory Framework (RRGs)

## ➤ Risk Retention Groups

- Hybrid state and federal law
- At least two companies engaged in similar or related business
- All insureds must be owners and vice-versa
- Liability coverage only
- Can write direct business in all states
- Pays insurer's premium tax
- Effectively regulated like a traditional carrier:
  - Must use NAIC biographical affidavit form
  - Files NAIC yellow blank financial statement quarterly and annually
  - Risk based capital calculation
  - Corporate governance requirements, including majority of independent directors and rotation of audit partners

## Captives: Regulatory Framework (federal tax)

- Why is it important to be taxed as an insurance company for federal tax purposes?
  - Insured can deduct premium payments as Section 162(a) “ordinary and necessary” business expenses
  - Insurance company, including a captive, can establish and deduct reserves for the payment of future claims, including “incurred but not reported” (IBNR) claims
  - IRS Section 831(b) election for small insurers with up to \$2.45 million in annual premium allows no tax on underwriting income, only investment income
  - IRS Section 501(c)(15) election for insurers with up to \$600,000 in total income (including premium income) allow no federal tax on either underwriting or investment income

# FEDERAL INCOME TAX

# Fundamental Tax Tests for Insurance

## ➤ Non-Tax Business Purpose

- Not a Sham
  - Comply with good documents
  - Not participate solely for tax benefits
- Have Economic Substance
  - Objectively has substance outside tax benefits
  - Subjectively not for tax

## ➤ Insurance Tests

- Insurance Risk
- Risk Shifting
- Risk Distribution
- Common Notions of Insurance

# Fundamental Tax Tests for Insurance

- Insurance Risk -- financial consequences of an event
  - The IRS does not define what is an acceptable “insurance risk”
  - IRS distinguishes between
    - “insurance risk” – (at a minimum, presumably traditional risks qualify)
    - “investment risk” (investments can create gains; insurance risks do not)
    - “business risk” – not defined
      - imbedded warranty v extended warranty
      - what about non-traditional risks – cyber, trade receivables, etc.
      - what about “enterprise risks” – loss of key customer, reputation, etc.
- Risk Shifting
  - Captive assumes the risk; insured is relieved of the financial consequences
    - Insurance Company is sufficiently capitalized
    - No one guarantees the captive (compare cases)

# Fundamental Tax Tests for Insurance

- Insurance Distribution (sharing of enough risks)
  - Law of Large Numbers (law of averages)
  - Parent-Sub: enough unrelated business
    - IRS Rev. Rul. 2002-89: 50% unrelated business
    - 50% would be best practice; Harper Group had 30% unrelated business
  - Brother-Sister (no insured owns any of the captive):
    - Enough insureds, each with enough risks
      - IRS Rev. Rul. 2002-90: a dozen entities, each with between 5 and 15% of the risk (premium)
    - Enough “exposure units”
      - Securitas: “the risks don’t know who owns them”
      - Rent-A-Center: 3,000 stores, 7,000 vehicles, 15,000 employees
      - What is an “exposure unit”?
      - How many exposure units are needed to have insurance?

# Fundamental Tax Tests for Insurance

## ➤ Common Notions of Insurance

- Organized, Operated, Regulated as an insurance company
  - Courts have accepted the captive is organized and regulated
  - Courts in small captive cases have found the operation of the captive lacking, e.g.:
    - 60% of assets were loaned to children of captive owner: no payments due for 10 years
    - 50% of assets used to purchase insurance
    - policies issued after claims can be filed; policies confusing
    - premiums started with commercial rates, then detoured to “crazy town”
- Captive Adequately Capitalized (sufficient to meet domicile minimum?)
- Claims Payments
- Premiums are Reasonable
- Valid and Binding Policies



# Taxation of Insurance Companies

## ➤ Taxation of Insurance Companies – section 831(a)

- The primary tax benefit of insurance taxation is the ability of the insurance company to deduct the discounted present value of its insurance reserves
  - Case reserves
  - Development reserves
  - IBNR (incurred but not reported) reserves
- Compare to self-insurance in a captive arrangement
- There are other special provisions relating to unearned premium, tax exempt income, etc.

## ➤ Taxation of Small Captives

- Section 501(c)(15) – tax exempt – (\$600,000 gross receipts including affiliates; 50% premium)
- Section 831(b): premiums don't exceed \$2,450,000 (2022, and indexed)
  - Higher of direct premiums or net written premiums)
- Must meet one of two “diversification” tests: 80% unrelated or no estate planning
- Make an election with the return (no specific form)
- Irrevocable without consent of Commissioner
- Taxed only on investment income [NOT on insurance income]

# Audits of Small Captives

- The IRS has a VERY extensive and exhaustive audit initiative for small captives
  - IRS has declared that “microcaptives” are on the “Dirty Dozen” list
  - 12 dedicated audit teams
  - Looking for 200 experienced tax shelter lawyers – including for microcaptives
  - The IRS has won 4 of 4 small captive cases
  - Tax shelter promotor investigations of captive managers and other “promotors”
  - IRS says it will also deploy Tax Shelter unit, Criminal investigation, Office of Professional Responsibility, impose civil fraud penalty, etc.
  - In Notice 2016-66, the IRS declared microcaptives to be a “Transaction of Interest”
    - Requires filings by participants and pass-through owners involved in the captive transaction
    - Material advisors also had filings
    - A US District Court abrogated the Notice – will the IRS appeal? Will it follow this nationwide?
  - IRS enforced summons against Delaware Department of Insurance; on appeal to Third Circuit
  - GAO has questioned IRS audits of small captives
  - SIIA provided comments on Forms 8886 (duplicate filings of information already held)
  - President Biden Budget Proposal re: certain captives that elect section 831(b) are taxed
- IRS has made a public concession in Puglisi Egg Farm
- The industry has education arm (ICCIE), amicus briefs, best practices, lobbying

STATE INCOME TAX  
DELAWARE D&O INSURANCE  
EMPLOYEE BENEFIT IN CAPTIVES  
WASHINGTON STATE

# STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

- For complex corporate groups, a state may try to tax a portion of the income of the entire group on the basis of the state's connection to one part of the group (*e.g.*, a subsidiary)
- Traditionally, insurance companies were exempt from corporate income tax considerations because they were subject to a state's premium tax (with a few exceptions), and were required to file separate returns

# STATE INCOME TAXES – UPDATES AND CONSIDERATION

- Several states have sought to tax the income of a captive insurance company regardless of whether or not it was “doing business” in the state
  - The state adds the captive insurance company’s income to the corporate group of which it is part and which is subject to tax in the state
  - Can cause an administrative and tax burden for corporate groups that are doing business in multiple states
  - Important to review state filing obligations and weigh effect of potential state income taxation

# STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

## ➤ ILLINOIS

- *Wendy's Int'l Inc. v. Hamer*, 375 Ill. Dec 194 (2013)

## ➤ NEW YORK

- “Overstuffed captive” – taxes income of a captive if gross investment income exceeds gross premium income

# STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

- Some states focus their tax on “disqualified captives” with rules similar to New York
- MINNESOTA
  - Captive income is included in group income if it is a “disqualified captive”, **defined as a captive that receives less than 50% of its gross receipts from premiums**, or pays less than .5% of its total premiums under state insurance premium tax or comparable tax in another state

# STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

- Some states focus their tax on “disqualified captives” with rules similar to New York
- COLORADO
  - Taxes income of a disqualified captive insurance company, *i.e.*, a **captive that has gross receipts of 50% or less in premiums** (as defined by the Internal Revenue Code)
  - Disqualified captives not subject to premium tax (but note DPT obligations)



# STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

## ➤ OREGON

- Imposes a corporate activity tax (slightly different than in income tax – imposed on the privilege of “doing business” in Oregon) and kicks in after \$1m of commercial activity in Oregon
- “Commercial activity” means:
  - Total amount realized by a person, arising from transactions and activity in the regular course of the person’s trade or business, without deduction for expenses incurred by the trade or business

# STATE INCOME TAXES – UPDATES AND CONSIDERATIONS

## ➤ OREGON

- “Commercial activity” means:
  - If received by an insurer – as reported on the statement of premiums in the annual statement
  - Includes all gross direct premiums and gross surplus lines premiums received on Oregon home state risks
  - Excludes federally reinsured premiums or income between a reciprocal insurer and its attorney-in-fact, compensation, and proceeds received on the account of payments from insurance policies owned by the taxpayer

# DELAWARE ENACTS LEGISLATION TO PERMIT CAPTIVES TO WRITE D&O INSURANCE

- Generally, most companies purchase D&O coverage which, at a minimum, provides side a coverage for directors and officers which covers, among other things, obligations associated with derivative actions
- In Delaware and many other states, directors and officers sued in derivative actions cannot, by statute, be indemnified by the corporation in whose name the suit is brought

# DELAWARE ENACTS LEGISLATION TO PERMIT CAPTIVES TO WRITE D&O INSURANCE

- In the past, concern has been raised regarding using a captive for Side A coverage to insure, *e.g.*, derivative suits against directors and officers, because it appears to be indemnification as a result of the corporation paying all of the premiums and capitalizing the captive

# DELAWARE ENACTS LEGISLATION TO PERMIT CAPTIVES TO WRITE D&O INSURANCE

- Delaware has now passed legislation to allow a captive insurer **in any jurisdiction** to provide D&O insurance for directors and officers of a Delaware entity (including coverage for):
  - i. “Personal profit or other financial advantage to which such person is not entitled, or
  - ii. A deliberate criminal or deliberate fraudulent act or knowing violation of law
  - iii. If established by a final, non-appealable adjudication in the underlying proceeding”, *i.e.*, The captive can pay if the payment is made in a settlement

# DELAWARE ENACTS LEGISLATION TO PERMIT CAPTIVES TO WRITE D&O INSURANCE

- But some issues arise
  - What happens if the captive is not in Delaware and local law precludes indemnification in a derivative suit
  - What is insurance
    - Single purpose captive hastily formed
    - Longer term funding with other risks
  - Securities laws suits
  - Direct placement tax issue

# BENEFITS IN CAPTIVES

## ➤ Background

- Going back to early 1990's, idea to write employee benefits in captives, see Rev. Rul. 92-93 and Rev. Rul. 2014-15
- The issue, however, was that ERISA treated such transactions as prohibited transactions, *e.g.*, a transaction between a **plan** and an entity 100%-owned by the employer, *i.e.*, the captive

# BENEFITS IN CAPTIVES

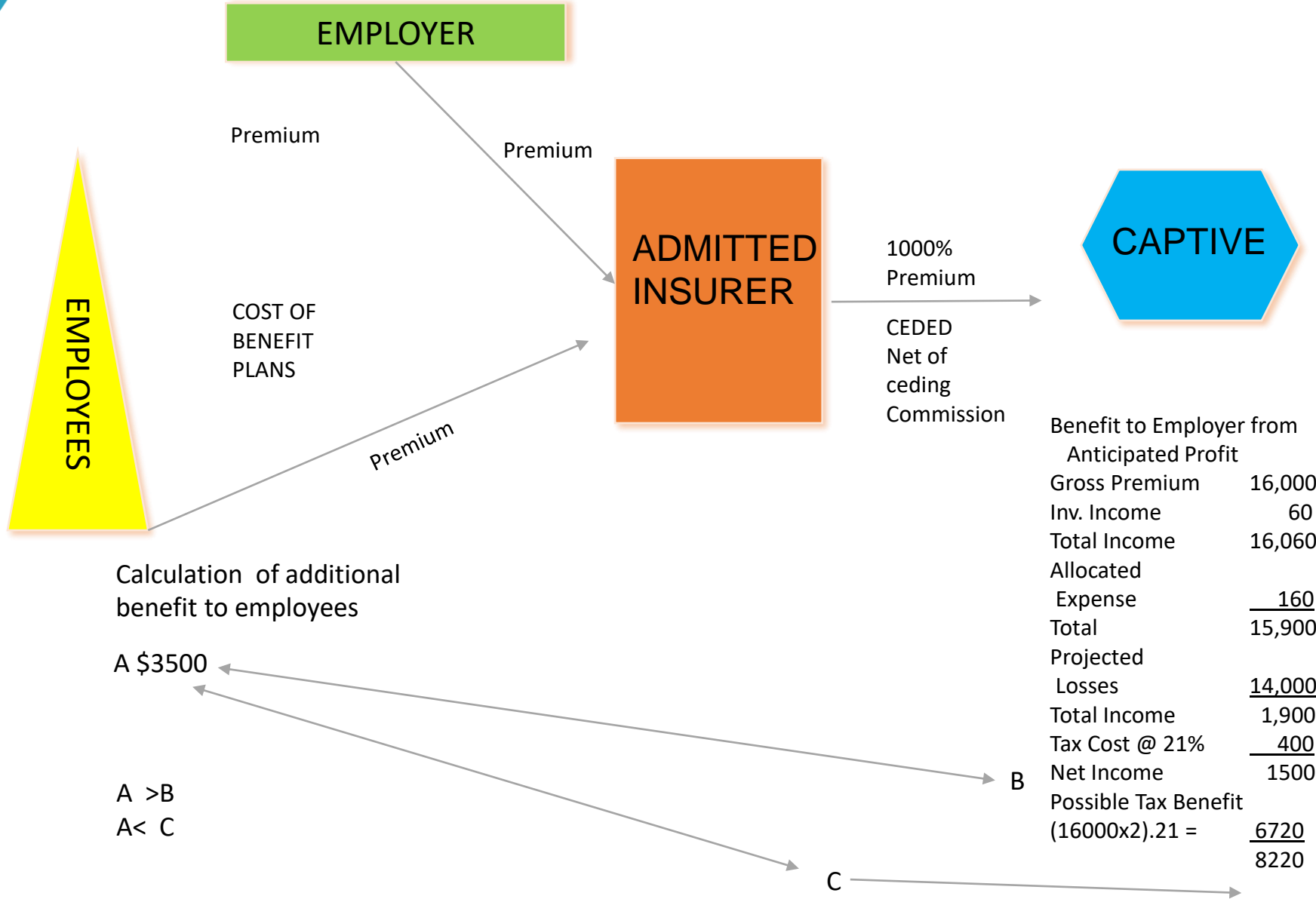
- In 2000, DOL issued a PTE in Columbia Energy wherein captive was permitted to reinsure welfare benefits
  - Captive based in Bermuda with 953(d) election and branch in Vermont
  - Independent fiduciary
  - Additional benefit to employees
  - Fronting company “A” rated
  - No commissions\*
  - Reinsurance indemnity (*i.e.*, not assumption)
- Over the years, DOL changed necessary benefit to employees



# BENEFITS IN CAPTIVES

## ➤ New rules

- Beginning in 2018, DOL set forth several new rules for securing an exemption
- Significant new burdens placed on independent fiduciary
- Required analysis to demonstrate principal benefits to be provided to employees, *i.e.*, 51% of benefit



# Washington State

- Beginning in 2018, Washington Insurance Commissioner brought administrative actions against captives owned by large companies based in state, alleging
  - Doing unauthorized business of insurance
  - Owed premium taxes
- 2020: Study of captive insurance commissioned by OIC and DOI at request of legislature
- Compromise legislation enacted in 2021

# Washington Captive Regulation and Taxation

- New law applies to “eligible captive insurers”
- Eligible captive insurer
  - Wholly or partially owned by for-profit or nonprofit entity or public institution of higher education
  - Insures risks of captive owner or affiliates or both
  - One or more insureds has principal place of business in Washington
  - Net assets  $\geq$  \$1M and can pay debts as they come due as verified by audited financial statement
  - Licensed as captive insurer in domicile
- Regulations do not apply to risk retention groups or captives that solely place insurance through surplus lines broker
- Non-eligible captive insurers are not authorized to do business in Washington, but NRRA home state rule and other federal law may preempt authority of Washington to tax or regulate

# Washington—Eligible Captive Insurer Registration and Tax

- Register with Insurance Commissioner (annual renewal April 1) and obtain approval of registration
- Annually by March 1 pay 2% tax on premiums for insurance directly procured by and provided to parent or other affiliate for Washington risks
  - Washington risks only
  - Reinsurance not subject to tax
  - Look back to 2011 (but no penalties or interest)
  - Captive affiliated with public institution of higher education exempt from tax

# Washington—Eligible Captive Insurer Restrictions

- May write property and casualty insurance only
- No stop loss for self-funded employee benefit plans
- May insure captive owner and affiliates only
- Preceding restrictions do not apply to reinsurance or surplus lines, but authority to write stop loss on surplus lines basis unclear
- May not provide WC insurance that directly covers workers but may indemnify self-insured employer for WC liability