LAW WATCH

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NON-PROFIT HEALTH CARE SYSTEM CAPTIVES: IS YOUR CAPTIVE AN "INSURANCE COMPANY" AND DO YOU WANT IT TO BE?

Executive Summary

***Action**: A captive insurance company is, for larger organizations, one of many "alternative risk transfer" vehicles. A single parent captive is the most common type of captive insurance company, which is, basically, a form of self-insurance. The strategic reasons behind the use of a captive include: better financial management, improved claims management, more effective loss prevention and risk management, and customized insurance programs.*

***Impact:** Before establishing a captive, an organization should conduct a thorough review of the fundamental underpinnings of a captive. While there are many tax advantages for a captive being characterized as an "insurance company", if the captive is part of an organization which is not-for-profit, the tax costs associated with the captive being an insurance company can greatly exceed any tax benefit.*

A captive insurance company is, for larger organizations, one of many "alternative risk transfer" vehicles. It can provide a variety of benefits if structured and operated properly. The basic premise for a single parent captive is that it is a form of self–insurance.

Thus, it is certainly not for everyone. Only those organizations which have the requisite financial where-with-all as well as the skill to manage a self–insurance program should consider the use of a captive. Other alternative risk transfer options include self–insurance, high deductible programs, retrospectively rated programs, along with a variety of "captive" programs, such as group captives, rent-a-captives (including segregated portfolio companies), and risk retention groups. The discussion in this article will focus on single parent captives, the most common type of captive insurance company.

The strategic reasons behind the use of a captive include: better financial management, improved claims management, more effective loss prevention and risk management, and customized insurance programs. Before establishing a captive, an organization should conduct a thorough review of the fundamental underpinnings of a captive. The factors to be considered include: predictable and controllable losses; available and cost effective reinsurance; effective risk control; adequate capitalization; a long term commitment and a method to exit the captive structure when desired.

One of the potential advantages to utilizing a captive insurance company over a traditional self-insurance program is the possibility to accelerate certain tax deductions. According to the Internal Revenue Code and related regulations ("Code"), in a typical self-insurance program, money that is set aside, or "reserved," for a future claim payment, is not deductible until the loss is paid. This is true even for known claims that have already been incurred. On the other hand, premiums paid for "insurance" are deductible when paid as the Code provides that certain insurance premiums are included as deductible "ordinary and necessary" business expenses. However, the terms "insurance" and "insurance contract" are not defined by the Code, but, rather, have been defined by the U.S. Supreme Court in ***Helvering v. Le Gierse*** ("***Helvering***") to include the presence of both risk shifting and risk distribution. Unfortunately, over the years, the Internal Revenue Service ("IRS") has had different ideas of what constitutes risk shifting and risk distribution.

Under the definition set forth in ***Helvering***, risk shifting and risk distribution are the primary requirements for insurance. Beginning in

1977, the IRS adopted the "economic family" theory, under which a parent corporation and its subsidiaries do not shift risk or distribute risk to an affiliated captive if the ultimate burden of loss is retained by the same economic family that may suffer a loss. As a consequence, the IRS concluded that "when there is no economic shift or distribution of the risk 'insured,' the contract is not one of insurance, and the premiums therefore are not deductible under section 1.162-1(a) of the regulations." Since the premium payments were not treated as payments for insurance, they were capital contributions. Moreover, the related captive insurer was not treated as an insurance company if its primary and predominant business activity was insuring or reinsuring the risks of related parties. In sum, the IRS maintained the position that there can be no risk shifting or risk distribution unless the economic burden of loss is transferred outside the economic family. The IRS's economic family theory was never adopted by the courts, and the IRS finally abandoned it on June 5, 2001.

On December 11, 2002, the IRS issued three new revenue rulings on the qualification of captives as insurance companies for federal tax purposes. These rulings focus on risk shifting and risk distribution under parent-subsidiary, brother-sister, and group captive insurer arrangements.

- Revenue Ruling 2002-89 addressed the deductibility of premiums in the parent-subsidiary captive arrangement by describing two scenarios. In the first scenario the parent's premium is 90% of the total premium and the parent's risk is 90% of total risk. Because the vast majority of the risk falls on the parent, this is not deemed insurance. In the second scenario, both the risk and the premium of the parent is less than 50% of the total risk, with the remainder of the risk provided by unaffiliated insureds, and because the parent's risk and premium is less than 50% of the total risk, it is deemed insurance.
- Revenue Ruling 2002-90 addresses the deductibility of premiums in the brother-sister affiliate captive arrangement. The IRS approved insurance company status where the risk insured by any one affiliate is no more than 5 to 15% of the total risk insured by the captive.
- Revenue Ruling 2002-91 addresses the group captive arrangement. The ruling scribed a situation in which a relatively small group of unrelated businesses formed a captive to compensate for the unavailability of commercially available coverage. None of the group members had greater than 15% voting control or more than a 15% capital interest in the captive, and no member's risk exceeded 15% of the total risk insured by the captive. The ruling also states that none of the owners (insureds) was subject to additional premium assessments if losses exceeded its premium, no member was entitled to a refund if losses were less than its premium, and the premium paid by any insured was available to cover losses of other insureds.

Under the Code, a corporation qualifies as an "insurance company" for a particular year if more than half of the corporation's business during that year consists of activities that, for federal tax purposes, constitute "insurance" (which also includes reinsurance).

Thus, with the abandonment of the economic family theory and the guidance set forth in the new Revenue Rulings described above, as well as existing case law, the issue of what constitutes "insurance" for tax purposes has probably never been more clear.

Accordingly, most "for-profit" organizations with captive insurance companies work diligently to structure their captive insurance arrangements to satisfy the requirements outlined above, in order for the transaction to constitute "insurance" and for the captive to qualify as an "insurance company" under the Code. For some, the tax advantages of the accelerated deductibility of losses may make the difference between the captive being an economically viable model or not.

While having a captive meet the requirements for an "insurance company" can have tax advantages (i.e., the accelerated deductibility in the form of "premium" for an ultimate loss payment), there are tax costs associated with such a structure. These "costs" can include state premium taxes (owed by the captive insurance company, or more likely a licensed "fronting" company utilized as part of the captive program) and/or independent procurement taxes owed by the insured on the premium paid to the captive. For example, in California the Revenue and Tax Code provides that an "insured" which independently procures insurance is responsible for a "Nonadmitted Insurance Tax" of 3% of gross premium; in Florida, this "independent procurement tax" is 5.3% of the gross premium. In addition to the state taxes, pursuant to the Code, if the captive is established "off shore" in a jurisdiction without a tax treaty with the United States, and has chosen not to make an election by which it agrees to be taxed as a US taxpayer, then the premium paid to the captive is also subject to a Federal Excise tax of 1% for reinsurance premium and 4% for direct insurance premium. Thus, if the "insured" is headquartered in California and independently procures insurance from its off shore subsidiary, the insurance premium is taxed at 7%, and if in Florida, 9.3%.

If the captive described above is part of a not-for-profit organization, the tax costs associated with the captive insurance company (i.e., the 7-9% "sales tax") can greatly exceed any tax benefit if indeed there is a tax benefit for the non-profit. In such a situation, it may be advantageous to establish the captive insurance program in such a way that it fails to meet the definitions for insurance under the Code so that the captive is not an insurance company.

Since the IRS no longer follows the economic family theory, the analysis of whether the captive insurance program satisfies the requirements of insurance must be based on the more recent revenue rulings and case law. Factors which can be utilized to take the captive program out of the insurance realm for tax purposes include: (1) using a thinly capitalized captive; (2) having the parent organization guarantee the obligations of the captive, (3) not including any unaffiliated risk in the insurance program, as the addition of any unaffiliated risk is quite commonly done to ensure that the captive satisfies the requirements of being an insurance company; and (4) using an insurance policy that is 100% assessable, therefore there is no risk transfer.

One such non-profit health care system took this approach and others, following its lead, are restructuring their captive insurance arrangements in a manner so as to minimize the tax costs.

Thus, is your captive an insurance company, and do you want it to be so?

If you would like further information regarding this subject, please contact **Kevin Fitzgerald** or **Jamshed Patel** in our Milwaukee office, **Richard Bromley** in our Chicago office, **Wes Strickland** in our Tallahassee office, or the member of the firm who normally handles your legal matters.

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