The State Tax Implications Of Captive Insurance Companies

by Cara Griffith

The Vermont Department of Financial Regulation announced in April that the state's captive insurance industry is off to a strong start. In the first quarter of 2012 the department issued eight new captive insurance licenses. According to Dan Towle, Vermont's director of financial services, in addition to seeing continued interest from companies looking to redomesticate to Vermont, there is a "solid pipeline of prospects," and two additional captive insurance companies have already been licensed in the second quarter.

The interest in captives is not limited to Vermont and has grown nationwide in the past few years. States are encouraging the formation of captives within their borders, and taxpayers can benefit from forming them. However, given the recent growth and the potential for future growth, state taxing officials may increase scrutiny to ensure that captives are properly formed and that tax benefits aren't the sole purpose of the insurance arrangement.

Captive Insurance Companies

A captive insurance company is, in the most general terms, an insurance company that is owned by a parent or operating company and that underwrites insurance for the parent and its operating subsidiaries. Jim Revels, a partner at the accounting firm Citrin Cooperman, said that "a captive insurance company is typically formed and owned directly or indirectly by the insured. Once the captive is established, the captive operates just like a commercial insurance company. The newly formed captive will issue policies, collect premiums, pay claims of the insured, but it will not offer insurance to the public."

Most major corporations have captive insurance companies. For example, Exxon Mobile Corp. has Ancon Insurance Co. Inc., Verizon Communications Inc. has Exchange Indemnity Co., Johnson & Johnson has Middlesex Mutual Assurance Co., and the Boeing Co. has Astro Ltd. Properly structured, captive insurance companies are legitimate insurance companies that underwrite risks that are being covered by a third-party insurer or that the companies would otherwise self-insure. Companies with hard-to-place insurance needs are prime candidates for a captive insurance company. For example, said Revels, oil companies have, for decades, "established captives to self-insure against environmental claims as a result from infrequent but potentially high-cost environmental disasters."

Some corporations may have multiple captives that provide insurance for different risks. For example, one captive may cover a corporation's product liability, while another captive provides insurance for the corporation's employee benefits liabilities. Captives also are not limited to publicly traded corporations. Midsize and privately held corporations, tax-exempt corporations, and even nonprofits may choose to form a captive insurance company to insure some of their risks. For example, Veritas Insurance Corp. is the captive insurance company of the University of Michigan.

Stuart H. Anolik, managing director at CBIZ MHM, said that a major benefit of captives is the ability to recapture the underwriting profits usually earned by commercial insurance carriers. That has the effect of lowering the cost of obtaining insurance coverage for the captive's owner, Anolik said. Captives may also provide more specialized coverage than a commercial insurance carrier. For example, a captive may provide coverage that is more narrowly tailored to its operating company's specific risk profile than is coverage offered by a retail insurer. A captive is permitted to underwrite nearly any kind of insurance coverage for its related and unrelated entities, provided its activities are within the usual scope of insurance company practice and the premium charged is deemed acceptable by those it insures and outside regulators.

A captive insurance company must be structured as a C corporation and can be domiciled onshore or

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offshore. There are advantages and disadvantages with either type of domicile. Determining where to domicile a captive depends on a variety of circumstances, including how comfortable the operating company is with the regulatory environment of a particular domicile and how that environment fits with its risk management objectives. For example, said David Kotowski, CEO and managing partner of Elevate Captives, although the regulatory environment in the offshore market may make it more attractive to form a captive than the domestic market, establishing domicile offshore is not always the right answer. If the parent is a U.S. company with all its offices in a handful of states, establishing an offshore captive might raise a red flag for the IRS and other U.S. regulators. However, if the parent is a hedge fund with its principal place of business in the Cayman Islands, establishing an offshore captive insurance company might make sense, he said. In the end, it is a facts and circumstances determination.

Vermont has been particularly aggressive in courting captive insurance companies; it was one of the first states to make it attractive for captives to locate onshore.

To encourage the creation of captives within their borders, some U.S. states have adopted or revised their captive insurance laws to be more attractive for the formation of captive insurance companies.[1] Attracting captive insurance companies can promote business travel to the state, create professional jobs, and increase tax revenue via premium taxes on the captive. For example, Vermont has been particularly aggressive in courting captive insurance companies; it was one of the first states to make it attractive for captives to locate onshore. It did so by creating a favorable regulatory environment for the creation and operation of captives. Although most states require the contribution of original capital to form a captive, Vermont began the trend of lowering the capitalization and reserve requirements to $250,000. That "lowered the entry fee into the market," Kotowski said. Previously, states had the same minimal capital requirements for captives as for other insurance companies, but capital requirements were considerably less offshore. Other states have since reduced or eliminated their premium taxes on captive insurance companies.

[1]Approximately 30 states have laws that permit the creation of captive insurance companies.

Federal-Level Taxation

The federal taxation of captive insurance companies is complex and a complete discussion is beyond the scope of this article. A captive insurance company can provide an operating company with specific tax benefits. The parent is permitted to deduct premium contributions made to the captive, provided some conditions are met. For many years, a major problem with captives was whether the operating company was able to take a deduction for premiums paid to its own captive. After many years of litigation, the IRS issued a number of revenue rulings from 2002 through 2008 that provided safe harbors for captive insurance companies. In essence, Anolik said, the IRS made it easier to maintain a compliant captive insurance company.

Provided a captive is formed and operated within the constraints of the safe harbors, the deductibility of premiums paid is no longer an issue, Anolik said. However, the IRS requires that risk shifting and risk distribution be present for a financial arrangement to be considered insurance.[2] Risk shifting means that the threat of economic loss has been transferred in some way to an insurer. Financial Accounting Standard No. 113 provides some direction, stating that there must be at least a 10 percent chance of a 10 percent loss.

Risk distribution involves examining whether enough independent risks are being pooled to invoke the actuarial "law of large numbers."[3] In essence, are enough independent risks being pooled to reduce the possibility that one large claim will exceed the premiums received by the captive? In the safe harbor rulings, the IRS provides detail on how to ensure sufficient risk distribution for captives. For example, IRS Revenue Ruling 2002-90 states that there is risk distribution if a captive insures 12 or more operating subsidiaries and none of the subsidiaries has coverage for less than 5 percent or more than 15 percent of the total risk insured by the captive. Also, IRS Rev. Rul. 2002-89 says that if the operating company has fewer than 11 qualifying subsidiaries, the captive can accept third-party risk from a risk pool.[4]

Provided the captive can meet the risk shifting and risk distribution requirements and therefore be treated by the IRS as an insurance company, the operating company can use the tax benefits. As noted above, among those benefits, Anolik said, is that premiums received (and on which investment income can be earned) by the captive facility, in many cases, will not be subject to tax because of

[2]*Helvering v. LeGierse*, 312 U.S. 531 (1941).
[3]IRS Rev. Rul. 2002-90.
[4]IRS Rev. Rul. 2005-40 provides additional clarification on the two listed rulings and provides case studies.

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federal income tax accounting rules allowing a deduction of a discounted value of reserves against premium and investment income. Alan Fine, a member in the Insurance Advisory Services group at Brown Smith Wallace LLC, also noted that captive insurance companies can deduct an estimate of losses they will pay out in the future. That is, a captive is permitted to take a deduction for cash that it sets aside as a reserve against potential future losses. That is, a captive is permitted to take a deducation for cash that it sets aside as a reserve against potential future losses, unlike other taxpayers, which have a requirement that the liabilities be fixed and determinable and the rules of economic performance be met before an item is deductible.

The tax treatment of premium income is determined by the domicile of the captive. U.S.-domiciled captives are subject to taxation as a typical property and casualty company. Those captives are taxed on their premium income as well as their investment income. However, under reg. section 1.162-1(a), captive insurance companies within a qualified captive arrangement are permitted to deduct business expenses from gross income, including expenses that are ordinary and necessary to the conduct of the insurance business. Those include advertising and selling expenses, as well as insurance premiums. Also, Revels said, captive insurance companies can deduct reserves on unpaid claims.

Small insurance companies can make an IRC section 831(b) election, which allows the captive to be taxed only on its investment income. A captive's investment income is subject to tax at the regular corporate tax rates. Because a captive insurance company is required under IRC section 816(a) to have more than 50 percent of its business activities involved in the issuance of insurance contracts or reinsuring risks underwritten by insurance, the captive must be conservatively invested (or at least have its level of investment closely monitored) or it will lose its status as an insurance company.

The captive cannot write more than $1.2 million in premiums each year. Kotowski noted that the passage of section 831(b) in 2004 and the corresponding tax benefits that stem from a section 831(b) election really provided an incentive to small and midsize companies to create captives. Section 831(b) captives can also be useful for estate planning purposes.

State-Level Taxation

Captive insurance companies are subject to state taxation in the state in which they are domiciled. That can mean that the captive or its parent will be subject to franchise, premium, or self-procurement taxes. Many states impose a premium tax on direct premiums written by admitted or licensed insurers or other insurers that are transacting business in the state. Captives are generally considered admitted insurers within their state of domicile and are subject to regulation and taxation in that state. That means that captives are typically subject to a state's premium tax. "The basis for imposing a premium tax varies from state to state," said Revels, and "each state may provide various exemptions from the premiums tax."

In general, states impose a premium tax based on the amount of premiums paid (less exemptions) to the insurance company when the insured (operating company) is domiciled in the same state as the insurance company, Revels said. For example, Delaware assesses a 0.2 percent tax on total gross premiums and a 0.1 percent tax on total reinsurance premiums. The state has set a maximum direct premium tax of $125,000 and maximum reinsurance premium tax of $75,000. Delaware will assess an annual minimum tax of $5,000 and an annual renewal fee of $300.

Alternatively, some states use a sliding sale. For example, Revels said, Vermont imposes a 0.38 percent tax on the first $20 million of premiums collected and a 0.285 percent tax on the next $20 million of premiums. The tax rate decreases down to a bottom of 0.072 percent, which is imposed on premiums collected in excess of $60 million. Vermont also uses a sliding scale for its reinsurance premium tax. In general, premium tax rates range from 1.75 to 3 or 4 percent, depending on the state and the line of insurance, said Fine. Captives are also typically taxed at a lower rate or there is a cap on the amount of premium tax a captive must pay, added Fine.

Most captives are licensed to engage in the business of insurance in their domiciliary state and limit their activities to that state to avoid regulation and taxation in other states. A parent or other related company that is located outside the captive's state of domicile may want the captive to underwrite risks in the foreign state. "Many states permit companies to obtain insurance on their own from insurance companies that are not licensed or located in the company's state of domicile," Revels said. The captive would be considered a non-admitted insurer in those states.

Many states require insureds to pay taxes on insurance premiums that were independently procured and paid to a non-admitted insurer. That's known as a self-procurement tax and is generally imposed on insureds that procure insurance directly from non-admitted insurers. "Self-procurement statutes vary from state to state as well," Revels said. "However, most of these states require all negotiations regarding self-procured insurance take place outside the state the company is domiciled." Self-procurement taxes are calculated on the premiums allocable to an insured's risk located in a state.

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Application of the Nonadmitted and Reinsurance Reform Act

Since the passage of the Nonadmitted and Reinsurance Reform Act (NRRA) as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, there has been debate in the captive insurance industry about the applicability of the law to captive insurance. The NRRA provides that only an insured's home state may collect premium taxes on non-admitted insurance. The act, therefore, restricts the ability of other states to directly collect premium taxes on non-admitted insurance covering risks in their state. The goal of the NRRA was to streamline the taxation and regulation of non-admitted insurance.

> ***The white paper concludes that captive insurers should not be subject to the NRRA's non-admitted insurance provisions because they are not placing non-admitted insurance within the meaning of the NRRA.***

According to a white paper prepared by the law firm McIntyre & Lemon PLLC, the target of the NRRA was surplus lines insurance, not captive insurance.[5] Surplus lines insurance is sold by insurance companies that are not admitted in a state, but still meet sufficient standards to be considered an eligible insurer that can have its policies sold by a state-licensed surplus lines producer. The white paper concludes that captive insurers should not be subject to the NRRA's non-admitted insurance provisions because they are not placing non-admitted insurance within the meaning of the NRRA. Also, the NRRA did not change the application of individual state's independently procured insurance laws and it should not restrict the collection of premium taxes paid for independently procured insurance to the home state of the insured, argues the McIntyre white paper.

Still, it is unclear at this point whether the NRRA will apply to captives. There has been no definitive determination. Most practitioners are advising captive insurance clients to monitor the situation and wait for further guidance.

Nexus

To avoid creating nexus with additional states, captive insurance companies must be careful to avoid establishing a connection with a state other than where they are located. As noted above, a captive is generally not subject to state tax in states where it is merely underwriting risks. The U.S. Supreme Court has held that merely underwriting risks in a particular state does not constitute conducting a trade or business in that state. In *State Board of Insurance v. Todd Shipyards*, the Court struck down a Texas premium tax that was levied on an out-of-state insurance transaction in which the insured property was located in the state.[6] The general holding from *Todd Shipyards* is that a state that has a connection to an insurance transaction, beyond the mere location of the insured risk, may be entitled to levy a self-procurement tax on the insured.

Because the captive will likely not have a connection to any state other than its domiciliary state, the key with self-procurement taxes is whether the insured has a connection to the state beyond the mere presence of the insured risk. Then nexus becomes a question. If a captive is formed in State A, it may underwrite risks in State B without being subject to State B's taxes. However, the State A captive and its insured must have no other contacts with State B. Contacts could include activities such as travel by the insured into state B or advertising by the captive in State B. The captive and the insured should take care to travel within State A to negotiate, execute, and pay insurance contracts. The captive and the insured should take care not to travel to State B to negotiate, execute, and pay insurance contracts.[7]

Revels noted a few of the factors (though this list is not exhaustive) to examine when determining whether a captive insurance company will be subject to regulation in the state in which the operating company is conducting business. Those include whether:

- all the insurers are domiciled outside the state where the operating company is conducting business;
- the captive has an office or agent in the state where the operating company is located;
- the captive solicits business in the state the operating company is located;
- the insurance arrangements were signed, issued, delivered, paid, and accepted out of the state where the operating company is located;
- the captive has a license or permit from the state the operating company is located; and
- the captive has to be examined or subject to any control by the state the operating company is located.

[5] *Available at* http://www.vermontcaptive.com/assets/files/Dodd%20Frank%20White%20Paper.pdf.

[6] 370 U.S. 451 (1962).

[7] For more on this topic, see *Dow Chemical Co. v. Rylander*, 534 U.S. 996 (2001).

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State Tax Benefits

Although state tax benefits should not be the primary reason for the creation of a captive, and there must be a legitimate business purpose before entering into that arrangement, captives can provide owners with significant state tax benefits, the largest of which may be that captives are generally not subject to income state in their domiciliary state. As noted above, captives may be subject to premium tax in their domiciliary state, but a captive's premium tax liability will likely be lower than what its income tax liability would be because premium tax is typically not imposed on capital contributions or surplus and the premium tax is often capped for captives. As an additional benefit, some states, like Arizona, do not impose premium tax on captives.

> ***Some states permit companies to transfer assets to the captive insurance company to bolster the captive insurance company's reserves.***

Revels further explained that benefits to the operating company include deducting insurance premiums, which can be taken on the operating company's state income tax return. Although the insurance premiums that are deducted in the operating company's state of domicile are taxed in the state in which the captive insurance company is domiciled, the only tax that will be paid on that income will be at the captive level, which could range from 0.001 percent to 4 percent based on the captive insurance company regulations in each state, Revels said. Also, some states permit companies to transfer assets to the captive insurance company to bolster the captive insurance company's reserves. Revels said that "this is a way to move income-producing assets out of the corporate state of domicile."

Delaware Series LLC Captives

Additional tax benefits from creating captive insurance companies vary from state to state. For example, Fine said, Delaware's series limited liability company entity may provide additional benefits for a captive and its operating company. Delaware recently modernized its Revised Captive Insurance Company Act. In 1996 Delaware began authorizing the series LLC entity. A series LLC is similar to a traditional LLC in that it is a separate legal entity. However, a series LLC has the ability to partition its assets, debts, obligations, liabilities, and rights among several series business units (SBUs). Each SBU operates as a separate unit that may have a different business purpose than other SBUs within the series LLC. Each SBU also has its own debts and liabilities and is treated as a separate taxpayer for federal income tax purposes.

In 2010 the Delaware Department of Insurance licensed the first series LLC captive insurance company as a "special purpose captive insurance company." The idea behind the series LLC captive was to eliminate a premium tax problem associated with sponsored or protected cell captives. Unlike a traditional captive, a sponsored captive is not formed by the companies that it will insure. Rather, it is created by a separate legal entity (for which it will provide no insurance). As a result, the insureds of a sponsored captive do not have an ownership interest in the captive. A sponsored captive may have separate underwriting accounts, termed cells.

Let's look at an example of how the series LLC captive functions. Assume, for example, that a corporation has two distinct types of risk and it wants to use a captive insurance company to underwrite those risks. If the company forms a serialized LLC captive in Delaware, it would place its risks in two SBUs within the one captive. That enables the operating company to have one management structure for both SBUs, which can translate into a cost savings. Serial LLC captives also provide tax savings. Rather than imposing a premium tax on each cell captive, the series LLC captive applies the premium tax at the LLC level, rather than at the SBU level. That could mean a significant tax savings for cell captives. Regardless of the number of SBUs, a single serial LLC captive will be treated as a single entity and will be subject to the $5,000 minimum premium tax requirement only once.

Conclusion

Captives have the ability to benefit both states and taxpayers. There is little doubt that states want captives to form within their borders because captives bring with them some economic benefits. And when properly structured, captive insurance companies are a legitimate tool for corporations, both large and small, that serve an economic purpose and provide significant federal and state tax benefits. But taxpayers should be on the lookout for increased state scrutiny of whether a captive is properly structured and is not a being used solely as a means of sheltering income from taxation.

> ***There could be an increased level of audit activity for the entire industry.***

Charles Barnwell said in 2010 that as more states adopt unitary combined reporting, there is less opportunity for tax base shifting. That has caused tax practitioners to increase their use of a variety of

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captives.[8] As state tax departments catch up with the most recent planning techniques, they will undoubtedly increase their level of scrutiny. Although auditors are most interested in scenarios that clearly show the creation of a captive for the sole purpose of obtaining state tax benefits, finding those targets is not easy. Therefore, there could be an increased level of audit activity for the entire industry.

States might be more likely to challenge a captive owning non-insurance-related operations. For example, states might be skeptical when a parent company forms a captive insurance company and the captive in turns forms a passthrough entity whose purpose is to hold and license intellectual property. The state may question whether the true purpose of the insurance company is underwriting risks or whether the purpose of the captive is to receive income from the passthrough and then be subject to little or no state tax itself. Regardless of whether that captive was formed for legitimate business purposes, the tax advisers to the corporate group should be prepared to defend their reason for creating the captive. ✰

[8]Charles F. Barnwell Jr., "Captive Structures and Other Tax Planning," *State Tax Notes*, Nov. 22, 2010, p. 555, *Doc 2010-22808*, or *2010 STT 224-3*.

Cara Griffith is a legal editor of State Tax Notes.

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