2024 Annual Conference

Texas Captives: Empowering Texas Business

Navigating Captive Insurance Taxes

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Navigating Captive Insurance Taxes

Agenda

- US Federal Tax Update
- State Tax Update
- Qualifying as an Insurance Company
- Issue Spotting & Hot Topics

Navigating Captive Insurance Taxes

US Federal Tax Update

- 2024 Presidential Election
  - Possible corporate rate increase, which can make captives more valuable
- Federal Excise Tax (“FET”)
  - The IRS continues to focus on FET collections and payments
  - 4% on direct premiums // 1% on reinsurance premiums
- IRC Section 953(d) Elections
  - There have been and continue to be significant delays in the IRS’s review and approval on 953(d) elections
  - Taxpayers should continue to be aware of DCL/SRLY limitations

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US Federal Tax Update

- Corporate Alternative Minimum Tax (“CAMT”)
  - Corporations with average annual AFSI greater than USD $1B over three consecutive years
  - Foreign parented companies must beet separate USD $100M income test related to US operations
  - CAMT will be accounted for in accordance with Accounting Standards Codification (ASC) 740-10-25-42 through 44 and ASC 740-10-30-10 through 12.
  - Deferred taxes will continue to be measured using the regular tax rate, not the AMT rate. Companies expecting to be in CAMT indefinitely may want to consider the impact on valuation allowances on existing deferred tax assets.
  - Notices 2023-7 and 2023-20

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State Tax Update

- Corporate State Tax vs. State Premium Tax
  - Insurance companies are generally subject to a premium tax in lieu of state income tax
- Unitary/Combined Rules
  - State-by-state analysis
  - Continued focus by state DORs on inclusion/exclusion of a captive insurance company in Unitary/Combined filings
  - Expected changes in legislation (most likely adverse to taxpayers) may result in additional state and local tax liability for the overall combined groups

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Direct Procurement Taxes

Pre-Dodd Frank

Access Mechanisms

- Licensed Placement
- Surplus Lines Placement
- Self Procurement
  - Remains in effect post-Dodd Frank except for payment mechanism

Direct Procurement Taxes

Pre-Dodd Frank

Direct Procurement

- Contemplates insured directly accessing unlicensed, unregulated insurer not doing business in the state
- Statutory provisions
  - Direct placement laws
  - Industrial insured exceptions

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Direct Procurement Taxes

Pre-Dodd Frank

Direct Procurement/Statutory Provisions/Direct Placements

- Comparison of provisions
- Requirement that elements to transaction occur outside the state
    - Negotiation
    - Issuance
    - Delivery
    - Payment of premium
    - No broker/agent as such
    - Telephone/mail

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Direct Procurement Taxes

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Direct Procurement/Statutory Provisions/Direct Placements

- Tax
  - Most states tax direct placements
  - Rate
  - Obligation to file and pay

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Direct Procurement Taxes

Pre-Dodd Frank

Direct Procurement/Statutory Provisions/Industrial Insured Placement

- Exception to doing business law
- Statutory “sophistication” standard
- Certain “in state” activities permitted
- Rate
- Obligation to pay and file
- Note federal income tax issue as to foreign captives

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Direct Procurement Taxes

Pre-Dodd Frank

Direct Procurement

- Note: Risk retention groups generally have a separate taxing provision imposed on the risk retention group

State Tax Authorities vs. Federal Tax Position

- Issue: No insurance for federal tax purposes
- Should direct placement/industrial insured taxes apply?
  - *In Matter of the Petition of Johnson & Higgins, State of N.Y. Division of Tax Appeals*
  - See *Matter of Stewart Shops* Corporation, DTA No. 825745 (N.Y. State Div. of Tax App. March 10, 2106), (N.Y. Tax App. Trib. July 27, 2017)

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Direct Procurement Taxes

Pre-Dodd Frank

Several states have no specific direct placement tax

- West Virginia
- South Carolina
- District of Columbia
- Massachusetts
- Virginia
- Note: Washington now seeks to tax the captive writing the business in Washington State, but seems to follow NRRA as described below

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Direct Procurement Taxes

Pre-Dodd Frank

Direct Procurement/Case Law

- *State Board of Insurance v. Todd Shipyards Corp.*, 370 U.S. 451 (1962)
- *Dow Chemical Co. v. Rylander*, 38 S.W. 3d 741 (Ct. App. Tex 2001)

Direct Procurement Taxes

Pre-Dodd Frank

Direct Procurement/Case Law

- *Ministers Life & Cas. Union v. Haase,* 30 Wis.2d 339 (1966)
- *Howell v. Rosecliff Realty Co.,* 52 N.J. 313 (1968)
- *Associated Electric & Gas Insurance Services, Ltd. V. Clark,* 676 A.2d 1357 (1996)

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Direct Procurement Taxes

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Non-Admitted and Reinsurance Reform Act of 2010 (“NRRA”)

- Effective date July 21, 2011
- Only applies to direct insurance, *i.e.*, not reinsurance

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Direct Procurement Taxes

Dodd Frank

Non-Admitted and Reinsurance Reform Act of 2010 (“NRRA”)

- No state other than home state of any insured may require any premium tax payment for non-admitted insurance. § 521
- Non-admitted insurance means any property and casualty insurance permitted to be placed *directly* [or through a surplus lines broker with a *non-admitted insurer* eligible to accept such insurance]. § 527(9)

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Direct Procurement Taxes

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NRRA - Definitions

- *Premium* Tax means, with respect to surplus lines or independently procured insurance coverage, any tax, fee, assessment, or other charge imposed by a government entity directly or indirectly based on any payment made as consideration for an insurance contract for such insurance, including premium deposits, assessments, registration fees, and any other compensation given in consideration for a contract of insurance. § 527(12)

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NRRA - Definitions

- *Independently procured* insurance means insurance procured directly by an insured from a non-admitted insurer. § 527(7)

Direct Procurement Taxes

Dodd Frank

NRRA – Definition of Home State

- *Home* State means with respect to an insured the state in which an insured maintains its principal place of business or, in the case of an individual, the individual's primary residence, or
  - If 100 percent of the insured risk is located out of the state referred to in clause (I), the state to which the greatest percentage of the insured's taxable premium for that insurance contract is allocated, provided, however, if more than 1 insured from an affiliated group are named insureds on a single non-admitted insurance contract, the term "home state" means the home state, as determined pursuant to subparagraph (A), of the member of the affiliated group that has the largest percentage of premium attributed to it under such insurance contract. § 527(6)

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Direct Procurement Taxes

Dodd Frank Consequences

A. Captive located in home state
B. Captive not located in home state
C. Issue: Captive in home state is not permitted to write a line of business desired to be written. Possible solution: multiple captives

Direct Procurement Taxes

Dodd Frank Consequences

A. Issue: Home state does not have a captive law. Possible solution: (A) utilization of deductible, but annual variability; or (B) create multiple policies, but keep terms separate

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Direct Procurement Taxes

Individual State Tax Issues: New Jersey

Johnson & Johnson v. Director

- Johnson & Johnson located in New Jersey with captive domiciled in Vermont since 1994
- Policies included among others WC, AL, GL, PL, Excess PL, Executive Protection, Property, Miscellaneous Other Casualty
- IPT imposed in N.J. on premium paid to non-admitted. J&J began paying tax in 2008 for years beginning with 2005. Paid only on N.J. portion
- In 2011, after NRRA, paid tax on 100% of premium paid

Direct Procurement Taxes

Individual State Tax Issues: New Jersey

Johnson & Johnson v. Director

- J&J made claim for approximately $55,000,000 plus interest asserting that the N.J. statute in response to NRRA was intended to apply only to surplus lines as it only refers to surplus lines, and, as such, the tax should only apply to premium relating to N.J. risk
- Court concluded the legislation was intended to apply to both surplus lines and non-admitted premium
- Appeal

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State Tax Update

- Recent State Activity
  - Washington State
    - An out-of-state captive that has an owner that has its principal place of business in Washington must register as a captive in Washington and annually pay a fee of $2,500; and
    - Must pay an annual premium tax on 2% of premiums directly procured by the captive on **Washington risks**.
    - Reinsurance assumed is not taxable; unclear on how ocean marine premium would be treated.
    - Principal place of business not defined (NY uses "nerve center" test from *Hertz Corp. v. Friend* for SPT).
  - Maryland
    - Maryland Insurance Administration has sent letters to companies operating in Maryland inquiring as to their compliance with the Maryland self-procurement tax. Companies with a home state out of Maryland have successfully argued against the application of the tax.
  - Florida
    - The Florida Department of Financial Services has sent to letters to Florida-based companies inquiring about their placement of insurance with offshore captives (specifically naming the captive in the letters) and their compliance with the Florida self-procurement tax. The state appears to be offering a limited lookback period (3 years) and waiver of late payment penalty.

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Navigating Captive Insurance Taxes

Qualifying as an Insurance Company

Establishing a well-managed captive insurance program can result in the following tax benefits:

- The Company and its affiliates may be able to deduct the premiums paid to the captive insurance company as an ordinary business expense
- The captive includes in income the premium paid by the Company and subsequently establishes an insurance reserve, which may be deductible (at discounted rates) for tax purposes
- Captive insurance companies are generally subject to premium tax in lieu of state income tax in many states
- Investment and underwriting income are generally not subject to state income tax

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Navigating Captive Insurance Taxes

Qualifying as an Insurance Company

The following criteria must be met for a captive to be treated as an insurance company for federal income tax purposes:

- Definition of an insurance company
  - An "insurance company" is a company where more than half business of which is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Sections 831(c) and 816(a)
- Insurance risk must be involved
  - The risks transferred from the insured must involve fortuity and constitute more than mere "investment" or "business" risk
- Risk transfer or shifting must occur
  - Risk shifting requires the transfer of economic consequences of a financial loss away from the entity (the insured) that is paying the premium. In other words, the insured entity pays the insurer an amount certain to bear its risk of loss.
- The captive must sufficiently distribute the risks that it holds
  - Risk distribution requires the pooling of funds by the insurer in order to spread the economic consequences of claims over a group that is large enough to yield predictable losses. There are several ways to achieve risk distribution, including:
    - The Safe Harbor Rule set forth by Revenue Ruling 2002-89
    - The Safe Harbor Rule set forth by Revenue Ruling 2002-90
    - Case law established in *Rent-A-Center* and *Securitas*
- The captive arrangement must comport with the "commonly accepted notions" of insurance
  - Regulatory oversight and adequate capitalization
  - Pays losses as claims are made
  - Other, less well-defined criteria

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Issue Spotting & Hot Topics

- State Tax Compliance Requirements
- Qualification – Contemporaneous Documentation
  - Best practice to document qualification status at the time a captive is formed and anytime changes to the insurance program, structure, etc. occur
  - Being an insurance company from a regulatory perspective is separate and distinct from qualifying as an insurance company for tax purposes
- "Opinion Shopping"
  - Beware of promoters, particularly in the IRC Section 831(b) space
- Disqualified insurance companies
- Related-party loans and parental guaranty's
- On-shore non-profits increased use of captives

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Proposed Legislation

- Section IRC 831(b) Proposed Regulations
  - April 11, 2023: IRS issued proposed regulations affecting most captive insurance companies making a Section 831(b) election
    - New regulations make Notice 2016-66 obsolete
    - “Upgrade” from Notice 2016-66 – many Section 831(b) captives become listed transaction instead of transaction of interest
    - If the captive meets the definitions in the proposed regulations, it must file Form 8886. Material advisors must file Form 8918. Same forms as Notice 2016-66.
    - Many captives and material advisors have been filing these forms since Notice 2016-66 – even after it was vacated by the District Court.
  - “Micro-captives” are a **listed transaction** if either:
    - Over the most recent 5-year reporting period, there is a financing agreement between the captive and a related party (*e.g.*, loanbacks); or
    - Over a 10-year reporting period, the captive has a loss ratio of less than 65%
  - “Micro-captives” are a **transaction of interest** if:
    - The captive issues a contract to the insured or reinsures a contract issued to the insured by an intermediary
    - The captive has a loss ratio of at least 65% if the captive has been in existence less than 10 years and no financing arrangement

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IRC 831(b) Cases

- *Keating v. Comm'r,* T.C. Memo. 2024-2 (Jan. 4, 2024)
  - Premium pricing, premium payments and claims approval done after the fact, not prospectively
  - Underwriting done well into coverage period based on "woefully inadequate information and methods" which were "disproportionately influences by meeting target premium," i.e., $1,200,000
  - Shareholders treated captive as a "tax-free savings account"
    - Captive posted collateral for workers' compensation deductibles "without any clear obligation to do so"
    - Captive never documented loan to shareholders for buy/sell life insurance policies and "unclear whether loans were enforceable or securitized"
    - Other loans not timely paid
  - Conclusions
    - Insured did not have insurance, but shifted liabilities to Captive so could not take losses N.O.V. it got no deduction – note this is not a reserve for self-insurance, e.g., *Spring Canyon Coal, Anesthesia Service Medical Group*
    - Distributions to taxpayers were dividends

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IRC 831(b) Cases

- *Swift v. Comm'r,* T.C. Memo. 2024-13 (Feb. 1, 2024)
  - The Swift captives insured, at most, three entities (in 2012), which dropped to two in 2013 and issued only nine lines of coverage in 2012 and 2013 and six lines in 2014 and 2015.
  - The Swift captives' six or nine policies covered an operation spanning approximately 28 locations (as of 2015) and a workforce that ranged between 530 (2012) and 341 (2015) workers during the years at issue, including its independent-contractor physicians.
    - "there was no geographic diversity . . . in the entities that [the Swift captives] insured." *See id.* at *38. Clinic's locations were concentrated in the San Antonio-Austin area, within a 100-mile radius, particularly significant given the heavy investment in terrorism and political violence insurance.
  - Other Areas of Concern
    - Premiums paid to captive vs. for commercial insurance – lack of loss history
    - Premium amounts shifted based on taxpayer request and seemed engineered for tax reasons
    - Types of coverage (terrorism, political violence coverage)
    - Taxpayer draft the medical malpractice policy himself
    - Claims reported after reporting period and exceeding policy limit were still paid
    - Premiums were invested in real estate
    - Policy allowed claims to e paid by promissory note

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IRC 831(b) Cases

- *Patel v. Comm'r,* T.C. Memo. 2024-34 (Mar. 26, 2024)
  - Premium pricing was 12 times higher than the premiums for the commercial policies
  - Entered a risk pool without performing due diligence
  - There was no evidence that the 51 percent of premiums ceded to the risk pool was actuarially determined – in fact it was implied that the amount was arbitrarily selected to comply with caselaw and a perceived safe harbor for risk distribution
  - Significant differences between risk pool utilized here and others like Green Island
  - Court held that 3 or fewer insured entities with 7-8 officers, 5 doctors, and fewer than 100 employees were insufficient to provide risk distribution
  - Conclusions
    - Court rejected patient visits and procedures as the relevant risk unit, concluding that the patient interactions were not relevant to the coverages provided by the captives
    - Court focused on limited geographical area and a single industry of the risk units and insured entities
    - Court determined captive premiums out of line with commercial premiums
    - Court noted that no feasibility study was done for either captive nor was there an analysis of the need for a captive
    - No claims made during the years at issue

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IRC 831(b) Cases

- *Royalty Management Insurance Company, Ltd. v. Comm'r,* T.C. Memo. 2024-87 (Sept. 16, 2024)
  - What not to do
    - Reinsure from an insurance company not in existence yet
    - Rely on a feasibility study done in two days that didn't review the mineral leases
    - Rely on a feasibility study not coinciding with risks you insure (Title warrant on mineral leases vs. standard)
    - Carry no commercial coverage and max out captive without agreeing to actuarial support
    - Insure coverages that make you go hmm…like product reword in this situation
    - Withdrawing cash like a piggy bank

Questions?

THANK YOU!

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