Captive Tax: Recent Developments and Future Activity

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Agenda

- Section 831(b) Amendments
- Captive Tax Tests and RVI
- IRS Scrutiny: Captives Electing Section 831(b)
- Medical Stop Loss
- Rent-A-Center and Securitas
- Acuity
- Validus and IRS Business Plan
- State Taxation

What Hasn't Changed

- **On their face, the amendments do not have anything to do with the definition of insurance.**
  - If the arrangement qualified as insurance before the amendments, it remains a good insurance arrangement after the amendments
  - If the captive fails to meet the new tests in 2017 or beyond, it is still an insurance company for tax purposes. The consequence will be that it is taxed under section 831(a), just like any insurance company with more than $2.2 million of premiums (more than $1.2 million in premiums in 2016 or before)

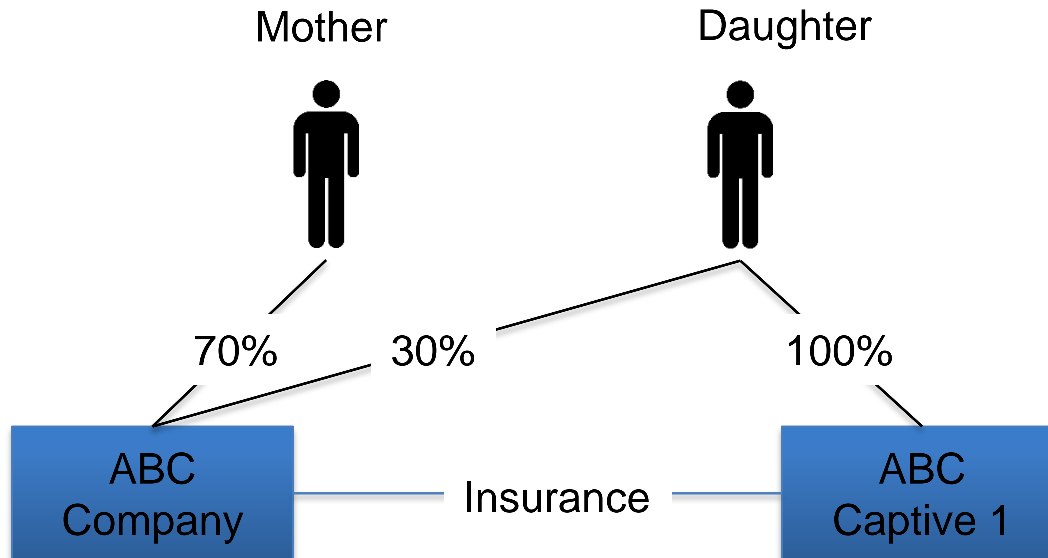
Protecting America From Tax Hikes Act of 2015

- **Protecting America from Tax Hikes of 2015 (HR 2029) which passed December 18, 2015 included changes to section 831(b):**
  - The maximum premium is increased to $2,200,000, and indexed for inflation.
  - The captive must meets one of two diversification tests:
    - No policy holder pays 20% of the premiums
    - No wealth transfer
  - Effective for years beginning after December 31, 2016

Protecting America From Tax Hikes Act of 2015, *cont*

- **Must meet one of two:**
  - Test 1: No more than 20% from any one policy holder
    - Premiums are the greater of net written or direct premiums
    - Related insureds are treated as one policy holder
  - Test 2: The spouse and lineal descendants cannot own more in the insurance company than the operating entity
    - Examples are provided below
    - There is a 2% de minimus tolerance for different ownership, which the IRS is authorized to change

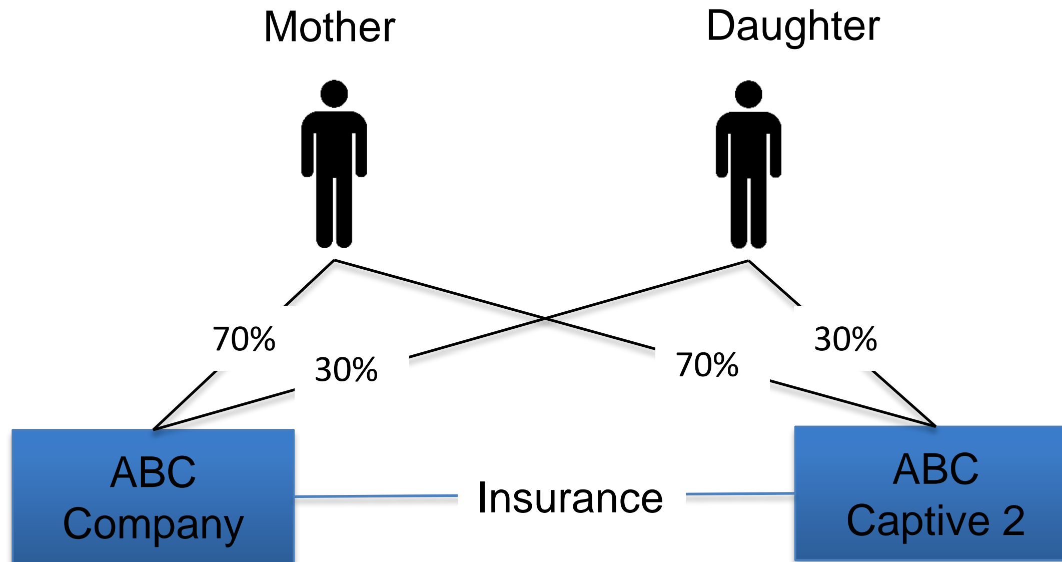
Captive 1



Because Daughter owns more in Captive* [100%] than she owns in Business [30%], Captive 1 is not eligible to make an election under section 831(b)

* subject to the 2% de minimus rule

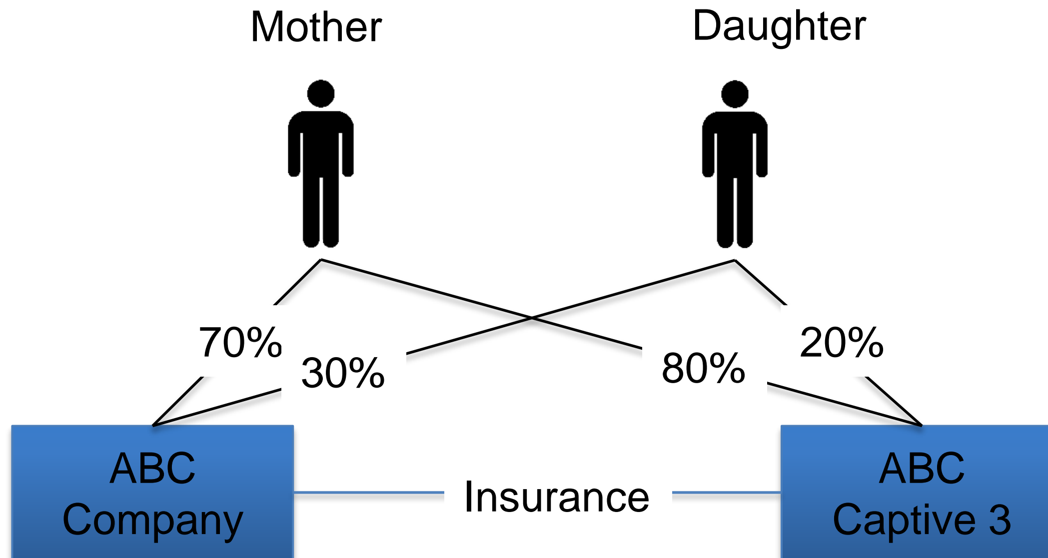
Captive 2



Because Daughter owns no more in Captive* [30%] than she owns in Business [30%], Captive 2 is eligible to make an election under section 831(b)

* would also be subject to the 2% de minimus rule, if needed

Captive 3



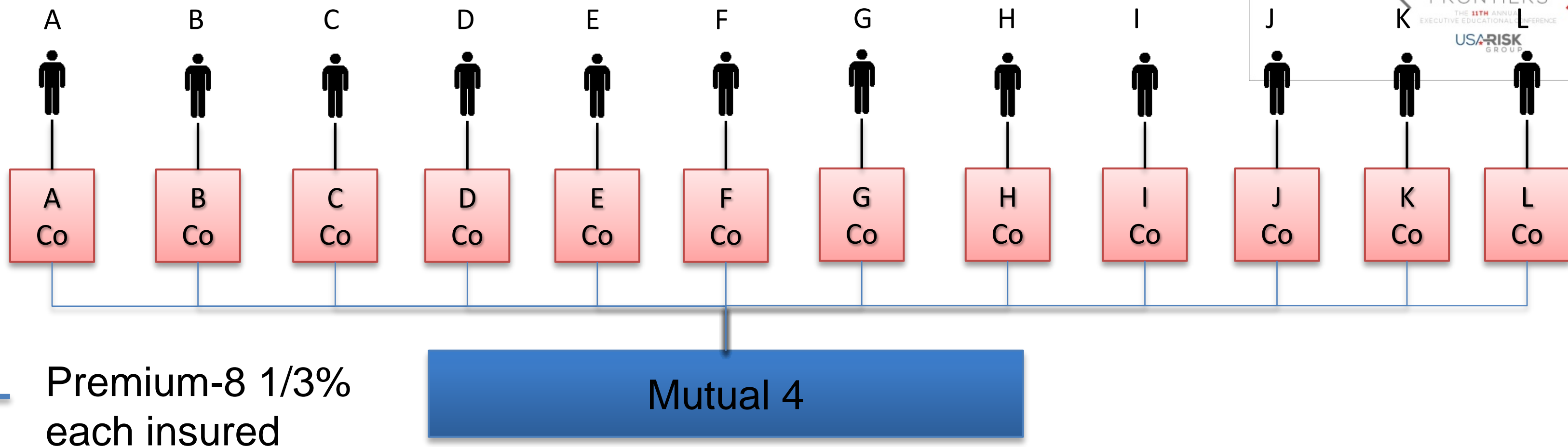
Because Daughter owns no more in Captive* [20%] than she owns in Business [30%], Captive 3 is eligible to make an election under section 831(b)

* would also be subject to the 2% de minimus rule, if needed

Summary of Examples

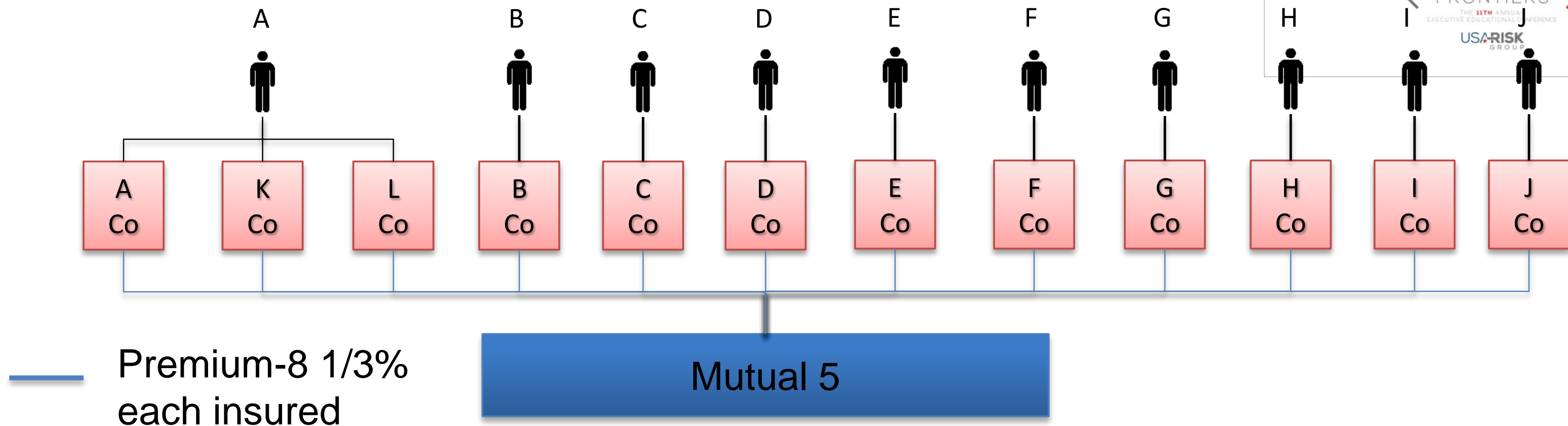
Owner	Business %age Owned	Captive %age Owned	Eligible for 831(b) Election
	Captive 1		No
Mother	70%		
Daughter	30%	100%	
	Captive 2		Yes
Mother	70%	70%	
Daughter	30%	30%	
	Captive 3		Yes
Mother	70%	80%	
Daughter	30%	20%	

Mutual 4



12 corporations (A Co., B Co., C Co., etc.) insure with a mutual insurance company. A owns A Co., B owns B Co., etc. A through L are unrelated. Each of the insureds pays 8-1/3% of the premiums. The mutual would meet the 20% diversity test because no policy holder pays more than 20% of the premiums.

Mutual 5



12 corporations insure with a mutual. A owns A Co., B owns B Co., etc. though J owns J Co. In addition to A Co., A also owns K Co. and L Co. Each of the insureds pays 8-1/3% of the premiums. The mutual would not meet the 20% diversity test because A Co., K Co. and L Co. are treated as one policy holder that pays more than 20% of the total premiums.

Open Questions

- The three goals of the amendments are narrow; they do not go into effect until 2017
- Over the next year there may be interpretations by the IRS and people will read the statute in light of specific fact situations
- For instance, if 20 equal insureds insure with a commercial front, which reinsures with a group captive, is that one policy holder or twenty 5% policy holders
- How does the "relatedness" apply where the next generation owns differing amounts in the operating entities ?

Tax Tests

- Non-Tax Business Purpose
- Insurance Risk
- Common Notions of Insurance
- Risk Shifting
- Risk Distribution

Residual Value Insurance – TAM 201149021

- LESSORS LEASED EQUIPMENT TO CUSTOMERS WITH A PROJECTED VALUE OF $X
- FOR EXAMPLE, A RENTAL CAR COMPANY MAY LEASE FLEETS OF CARS TOTALING 2,000,000 CARS OR A COMPUTER COMPANY MAY LEASE 2,000,000 COMPUTERS
- REAL ESTATE WAS ALSO INVOLVED
- THE LESSOR PURCHASED INSURANCE FROM AN UNRELATED INSURANCE COMPANY TO PAY TO THE EXTENT THE ACTUAL VALUE OF THE EQUIPMENT IS LESS THAN $X (EXCLUDING PHYSICAL DAMAGE)

Residual Value Insurance TAM 201149021

- TAM 201149021 DETERMINED THAT THIS IS NOT INSURANCE – IT IS NOT AN INSURANCE RISK, BUT MORE OF AN INVESTMENT RISK (ECONOMIC FLUCTUATIONS AND NOT FORTUITOUS PHYSICAL ACT)
- THERE WERE NO COMMON NOTIONS OF INSURANCE – ECONOMIC RISK AND GAP BETWEEN LOSS AND PAYMENT
- THERE WAS NO RISK DISTRIBUTION – THE SAME ECONOMIC ISSUES AFFECT THE NATIONWIDE MARKET
- THIS CASE IS NOW IN TAX COURT

RVI Guaranty Ltd

- The Tax Court decided RVI Guaranty Ltd in favor of the taxpayer
- This is the taxpayer that was the subject of TAM 201149021
- The Tax Court found that the risks involved were insurance risks
- The IRS did not appeal the decision

IRS Scrutiny

- **There are anecdotal reports that the IRS is auditing a substantial number of captives electing to be taxed under section 831(b)**
- **Tax Shelter Promoter Investigations:**
  - One or more captive managers are being investigated to determine if they are tax shelter promoters
- **Audits of Captives Electing Section 831(b) – some of them are customers of the captive manager(s) under investigation and some are captives associated with operating companies otherwise selected for audit**
- **Just because the IRS is investigating an issue or conducting an audit does not mean that anyone has done anything wrong**
- **There have been no results announced from the investigation(s)**

Audits of Captives Electing Section 831(b)

- **The audits are very exhaustive and usually include an interview of the principal(s) and comprehensive information requests**
- **Comprehensive information document requests:**
  - Information from the inception of the captive, even if it preceded the years under audit
  - All emails, marketing materials, etc.
  - Comprehensive questions on how one got involved in the captive and was consulted
  - What commercial insurance was in place, what are the gaps and exclusions, how the captive program fit

Audits of Captives Electing Section 831(b), *cont.*

- **Comprehensive Information Document Requests (cont):**
  - What is the operating company's risk management program
  - How were the premiums priced
  - For the ten years prior to its inception, were there any losses that would have been covered by the captive program had it been in place
  - What is the loss experience of the related party and pool insurance
  - What are the investments

IRS Scrutiny: The Dirty Dozen

In 2015 and 2016, the IRS identified Tax Shelters as one of its "Dirty Dozen." For the first time, captives electing section 831(b) were linked to tax shelters.

- *"The promoters assist with creating and "selling" to the entities often times poorly drafted "insurance" binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant "premiums," while maintaining their economical commercial coverage with traditional insurers."*
- *"Total amounts of annual premiums often equal the amount of deductions business entities need to reduce income for the year; or, for a wealthy entity, total premiums amount to $1.2 million annually to take full advantage of the Code provision. Underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient."*

Avrahami v Commissioner

- **Avrahami v Commissioner is the first case involving a captive electing to be taxed under section 831(b)**
  - The briefs have been filed; an opinion is expected in 2016
- **The IRS is arguing that the contracts did not have "insurance risk" but rather investment or business risk.**
  - The IRS does not believe that economic substance is present in the captive insurance arrangement and thinks that the arrangement appears to be tax motivated.
  - The captive also participated in a pool that insured against terrorism, primarily against terrorism risks not available in the commercial market.

Medical Stop Loss Coverage

- Who uses it?
  - Used by self-insured employers
- It is not a health insurance policy
- Employees are not a party to the contract, it is usually a contract between the employer and the captive
- Captive indemnifies the employer for claims under the employers' ERISA plan

Medical Stop Loss

- **NAIC Model Stop Loss Insurance Act**
  - Developed to limit stop-loss insurance policies with low attachment points functionally acting like health insurance policies, but avoiding state mandated health benefits
  - Prohibits insurers from issuing stop-loss insurance policy that has:
  - Individual annual per claim incurred attachment point less than $20,000
  - Annual aggregate claims incurred attachment point:
  - Small employers (50 or fewer employees)-less than greater of (1)$20,000, (2)$4,000 times number of employees or (3) 120% annual expected claims
  - Larger employers (51 or more employees)- less than 110% of annual expected claims
- Direct coverage of health care expenses of an individual

NAIC Model Stop Loss Insurance Act

- NAIC sought in 2012 to increase attachment points for small employers to $60,000 per employee and $15,000 per employee in aggregate, but it never passed out of Committee
- •Very few states have adopted either the earlier version of the model law or the updated version in its entirety; although a number of states regulate stop-loss insurance either through explicit regulation or “deskdrawer”rules.
- •DE, NY, and OR prohibit stop-loss insurance to small groups(50 employees in OR and NY, and 15 in DE)
- •NC applies underwriting, rating and other small group health insurance requirements to stop-loss insurance issued in the small group market

PPACA and Stop Loss

- What does PPACA say about stop-loss insurance?
  - Nothing
  - Stop-loss insurance coexists with PPACA for both large and small self-insured employers
  - Heath insurer fee and reinsurance, risk corridor and risk adjustment programs do not apply to stop-loss insurance
  - Small employers offering coverage cannot impose annual or lifetime benefit limits; stop-loss effectively required
- May 1,2012 Federal Information Request
  - IRS, EBSA and CMS issued a request for information regarding use of stop-loss insurance, with eye on potential future regulation
  - Focus was on low attachment points
  - To date nothing has come of this information request

Captive Stop Loss Insurance

- Generally, most state captive insurance laws permit captive insurers to issue stop-loss insurance
- Limited in states like DE, NY and OR that prohibit stop-loss insurance generally
  - Employers with principal place of business or other significant business office outside of these states should be able to buy stop-loss insurance even though they have employees located in these states
- Do state stop-loss insurance minimum attachment points apply to captive stop-loss insurance?
- If NRRA ,or state law (see IL), makes a captive insurer a surplus lines insurer, is stop-loss insurance a prohibited line of insurance, especially in those states where it is considered a line of health insurance?

Medical Stop-Loss a Third Party Coverage?

- Only guidance to date is US DOL 2014-01
- IRS nor the courts have provided any

RENT-A-CENTER

- ON JANUARY 21, 2014, THE TAX COURT HELD THAT RENT-A-CENTER HAD A VALID INSURANCE ARRANGEMENT FOR FEDERAL TAX PURPOSES ON A 10-6 VOTE
- VERY HIGH PROFILE CASE – IT WAS THE FIRST SUBSTANTIVE CAPTIVE CASE IN 20 YEARS
- THE IRS DID NOT APPEAL
- SIXTEEN JUDGES FILED 4 OPINIONS: 7 JUDGES (INCLUDING TRIAL JUDGE) FOR THE TAXPAYER; A CONCURRING OPINION ADDED 3 JUDGES; A 5 JUDGE DISSENT; 1 JUDGE DISSENTED ON PROCEDURAL GROUNDS (BUT WOULD HAVE VOTED FOR IRS)
- LOT OF “INSIDE BASEBALL” AND LAW SCHOOL PROFESSOR ASPECTS
- INTERESTING PRACTICAL ASPECTS ALSO

RENT-A-CENTER

- RENT-A-CENTER IS A PUBLIC COMPANY WHICH RENTS FURNITURE, ETC. TO THE PUBLIC
- FROM THE BRIEFS (NOT THE OPINION), RENT-A-CENTER HAD 3 TO 12 SUBSIDIARIES [DEPENDING ON THE YEAR], BUT IN EACH YEAR ONE ACCOUNTED FOR 61 TO 68% OF THE TOTAL PREMIUMS OF THE CAPTIVE
- THE CAPTIVE INSURED THE DEDUCTIBLES OF RENT-A-CENTER'S G/L, AUTO AND WORKERS' COMP COMMERCIAL INSURANCE PROGRAM ON DECEMBER 31
- SOME COMMERCIAL CARRIERS DECLINED TO WRITE THE CAPTIVE COVERAGE OR WOULD DO SO AT A MUCH HIGHER PRICE

RENT-A-CENTER

- THE CAPTIVE CHARGED A PREMIUM, WHICH WAS INTERNALLY ALLOCATED TO THE SUBSIDIARIES (ALTHOUGH [FROM THE BRIEFS] IT APPEARS THE ALLOCATION COULD NOT BE REPLICATED)
- RENT-A-CENTER DEDUCTED PREMIUM PAID IN THE FOLLOWING SEPTEMBER UNDER RECURRING ITEM EXCEPTION
- THE CAPTIVE APPARENTLY INCLUDED ALL PREMIUM IN INCOME FOR TAX, BUT ACCRUED DAILY FOR BOOK, CREATING A DEFERRED TAX ASSET (DTA)
- THE CAPTIVE TREATED THE DTA AS AN ASSET FOR REGULATORY SOLVENCY TESTS, WITHOUT WHICH IT WOULD HAVE BEEN INSOLVENT IN THE EARLY YEARS
- RENT-A-CENTER PARENT (NOT AN INSURED) GUARANTEED THE DTA (LATER $25 MILLION) TO BERMUDA

RENT-A-CENTER

- ONCE THE DTA WAS NOT NEEDED TO MEET THE SOLVENCY REQUIREMENTS, THE GUARANTY WAS WITHDRAWN
- THE CAPTIVE PURCHASED PARENT TREASURY SHARES
- **PLURALITY OPINION**
  - NOT A SHAM; MYRIAD OF SIGNIFICANT AND LEGITIMATE NON TAX REASONS
  - NO CIRCULARITY OF FUNDS (GOV'T EXPERT AGREED)

RENT-A-CENTER

- **PLURALITY OPINION**
  - COMMON NOTIONS OF INSURANCE FOUND
  - CAPTIVE DID NOT HAVE TO OPERATE THE SAME AS COMMERCIAL INSURERS ON A NUMBER OF ASPECTS
  - FUNDAMENTALLY SHIFTED RISK TO CAPTIVE AND MET THE BALANCE SHEET TEST
  - COURT ESSENTIALLY ADOPTED HUMANA 6TH CIRCUIT (BROTHER SISTER) FOR FIRST TIME
  - GUARANTY DID NOT VITIATE RISK SHIFTING
    - DIFFERED FROM OTHER CASES
    - DID NOT INVOLVE AN UNDERCAPITALIZED CAPTIVE
    - WAS NOT ISSUED TO OR FOR AN UNRELATED INSURER
    - NARROW PURPOSE WAS TO BACK DTA; NEVER USED

RENT-A-CENTER

- **PLURALITY OPINION**
  - RISK DISTRIBUTION
    - THE OPINION DOES NOT ADDRESS THE CONCENTRATION OF RISK (61 TO 68% OF PREMIUMS PAID BY ONE SUBSIDIARY)
    - IT ONLY REFERENCES THE NUMBER OF STATISTICALLY INDEPENDENT RISKS (UP TO ABOUT 20,000 EMPLOYEES, 3,000 STORES, 8,000 VEHICLES)

RENT-A-CENTER

- **CONCURRING OPINION**
  - THE CONCISE (40 PAGES) PLURALITY OPINION SETS FORTH FACTS AND CIRCUMSTANCES; CONCURRING OPINION WAS TO RESPOND TO THE 5 JUDGE DISSENT
  - CAPTIVE ADEQUATELY CAPITALIZED AFTER CONSIDERING LONG TAIL NATURE OF COVERAGE AND EXCESS COVERAGE
  - PREMIUMS ACTUARIALLY DETERMINED
  - GUARANTY IMMATERIAL: CAPTIVE NOT UNDERCAPITALIZED AND WITHDRAWN WHEN NOT NEEDED

RENT-A-CENTER

- **DISSENTING OPINION (5 JUDGES)**
  - CAPTIVE DID NOT OPERATE LIKE A “REAL” INSURANCE COMPANY IN A NUMBER OF ASPECTS
  - WOULD FIND AGAINST THE TAXPAYER ON
    - GUARANTY
    - CAPTIVE UNDERCAPITALIZED
    - CAPTIVE ILLIQUID -- TREASURY SHARES
- **BOTH DISSENTS**
  - NO NEED TO OVERRULE TAX COURT’S HUMANA DECISION

SECURITAS v COMMISSIONER - TC MEMO

SECURITAS AB IS A SWEDISH SECURITY COMPANY (AB) WITH A US HOLDING COMPANY (US) THAT ACQUIRED PINKERTON'S, BURNS SECURITY AND OTHER SECURITY COMPANIES

- US OWNED TWO CAPTIVES: PROTECTORS AND CENTAUR
  - CENTAUR WAS IN RUN-OFF AND WAS TAX-EXEMPT UNDER SECTION 501(C)(15)
  - PROTECTORS WAS A VERMONT CAPTIVE
- AB ORGANIZED AN IRISH REINSURANCE COMPANY
- IN 2004, 88% OF PREMIUMS WERE BY ONE SUB

SECURITAS v COMMISSIONER

- IN ORDER TO PROTECT THE SECTION 501(C)(15) TAX EXEMPTION, US GUARANTEED PROTECTORS' LOSSES, WHICH WAS NEVER CALLED UPON.

- A LOSS PORTFOLIO AND CURRENT RISKS WERE INSURED; THE PARTIES AGREED THEY WERE INSURANCE RISKS.

- THE TAX COURT DETERMINED THAT THE GUARANTY DID NOT INVALIDATE RISK SHIFTING. PARENTAL GUARANTEES DO NOT AUTOMATICALLY INVALIDATE A CAPTIVE ARRANGEMENT. HERE, PROTECTORS WAS ADEQUATELY CAPITALIZED AND THE OFFSET OF PREMIUMS AND CLAIMS DID NOT ADVERSELY AFFECT THE INSURANCE ARRANGEMENT.

SECURITAS v COMMISSIONER

- RISK DISTRIBUTION IS EVALUATED FROM THE PERSPECTIVE OF THE CAPTIVE.

- THE TAX COURT FOCUSED ON THE NUMBER OF STATISTICALLY INDEPENDENT RISK EXPOSURES 100,000 US EMPLOYEES AND 2,240 VEHICLES, RATHER THAN THE NUMBER OF ENTITIES --

  - IT QUOTED DR. DOHERTY, THE TAXPAYER'S EXPERT, WHO SAID: "IT IS THE POOLING OF EXPOSURES THAT BRINGS ABOUT THE RISK DISTRIBUTION -- WHO OWNS THE EXPOSURES IS NOT CRUCIAL."

SECURITAS v COMMISSIONER

THE TAX COURT FOUND THAT THE ARRANGEMENT WAS INSURANCE IN ITS COMMONLY ACCEPTED SENSE BECAUSE:

- THE CAPTIVES WERE ORGANIZED, OPERATED AND REGULATED AS INSURANCE COMPANIES
- THEY WERE ADEQUATELY CAPITALIZED
- THE POLICIES WERE VALID AND BINDING
- THE PREMIUMS WERE REASONABLE
- PREMIUMS AND LOSSES WERE PAID (SOME BY OFFSET)

POST RENT-A-CENTER

- RENT-A-CENTER AND SECURITAS WERE NOT APPEALED, WHAT IS THEIR STATUS FOR PLANNING PURPOSES:
  - IRS COULD ISSUE AND ACTION ON DECISION WITH ACQUIESCENCE OR NON-ACQUIESCENCE
  - IRS COULD CHANGE REVENUE RULINGS ON RISK DISTRIBUTION
  - INFORMAL IRS COMMUNICATIONS AT CONFERENCES
  - IRS COULD AWAIT FURTHER COURT OPINIONS IN OTHER CASES

POST RENT-A-CENTER

- POST RENT-A-CENTER PLANNING:
  - BIG QUESTION IS WHETHER RISK DISTRIBUTION CAN BE SATISFIED WITH SUFFICIENT EXPOSURE UNITS EVEN WITH ONE OR ONLY A FEW ENTITIES
  - IF SO, DOES THIS MAKE HOMOGENEITY A BIGGER ISSUE?
  - HOW MANY EXPOSURE UNITS ARE ENOUGH?
  - AWAIT MORE COURT DECISIONS OR IRS ACTION?
  - STILL AVOID GUARANTEES, TREASURY STOCK PURCHASE, ILLIQUIDITY, [NETTING?], ETC.

Acuity v IRS

- Case another in a long line indicating that reserves determined by an actuary and recorded by the insurance company will be determined to be fair and reasonable
- IRS challenged company's establishment of reserves on the basis of a worksheet.

Validus v United States

- There is an excise tax imposed on the insurance (generally 4%) or reinsurance (1%) of U. S. risks by a foreign insurance company
  - The IRS believed that if a foreign insurer reinsured U. S. risks to another foreign insurer, that a 1% “cascading” excise tax is due on the reinsurance of U. S. risks
  - District Court: no tax on retrocession
  - Court of Appeals: no tax on reinsurance between two foreign insurance companies
  - Revenue Ruling 2016-03

IRS Business Plan (Priority Guidance)

- The IRS publishes its Priority Guidance Plan annually; this is the IRS' Business Plan listing projects it hopes to work on during the year
  - The first item is the finalization of the cell/series regulations
    - Apply to domestic cells and series LLCs; it only applies to foreign cells engaged in insurance
    - Each cell or series is its own separate entity with its own EIN, tax returns and elections
  - "Guidance with respect to captive insurance"
    - No topics or other details provided

State and Local Taxes

- Background
  - Premium taxes imposed by captive jurisdiction
  - Direct placement taxes
  - Taxation of captive income

State and Local Taxes

- Pre-Dodd Frank
  - Direct Procurement
    - Contemplates insured directly accessing unlicensed, unregulated insurer
    - Statutory provisions
      - Direct placement laws
      - Industrial insured exceptions
    - Non-Statutory Provisions

State and Local Taxes

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

State and Local 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)
    - 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 2nd 1357 (RI Supreme CT (1996)

State and Local Taxes

- Dodd Frank
  - Non-Admited and Reinsurance Reform Act of 2010 ("NRRA")
    - Effective date July 21, 2011
    - Only applies to direct insurance, *i.e.,* not reinsurance
    - No state other than home state of an 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 though a surplus lines broker *with a non-admitted insurer* eligible to accept such insurance. § 527(9)

State and Local Taxes

- Dodd Frank
  - 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)

State and Local Taxes

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

State and Local 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 states, 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)**

State and Local Taxes

- Dodd Frank
  - Allocation
    - A state compact may be entered into, or states may otherwise establish procedures to allocate among the states the premium taxes paid to an insured's home state. § 521(b)(1)
    - To facilitate the payment of premium taxes among the states, an insured's home state may require surplus lines brokers and insureds who have independently procured insurance to annually file tax allocation reports with the insured's home state detailing the portion of the non-admitted insurance policy premium or premiums attributable to properties, risks or exposures located in each state. The filing of a non-admitted insurance tax allocation report and the payment of tax may be made by a person authorized by the insured to act as its agent. § 521(c)

State and Local Taxes

- Dodd Frank
  - Texas Rule 38 TEX 2609
    - Provides for tax on unauthorized insurer if tax not otherwise paid on transaction
      - Premium tax on authorized insurer
      - Surplus lines tax
      - Independently procured tax
    - Rate 4.85%
      - Applies generally to portion of risk allocable to Texas
      - If indemnity policy issued all risk deemed to be allocated to home state
        - » Texas
        - » Other

State and Local Taxes

- Illinois passed self-procurement taxes in 08/14;
- Effective 01/01/15
- Legislation already presented to repeal the law effective for the 2016 year
- Therefore, law is in effect for 2015

UPS v State of Indiana

- Case was about whether the captive insurance companies were “subject” to the premiums tax and if so, exempt from the corporate income tax

UPS v State of Indiana

- UPS was challenging the physical presence requirement of the premium tax
- Challenged the income tax under the Commerce Clause

UPS v State of Indiana

- Court held that the physical presence test is appropriate for the premium tax based on:
  - US Supreme Court holding in Todd Shipyards Corp.
  - Indiana and other state jurisdictions
- Commerce Clause challenge was denied on the basis of the Supreme Court’s interpretation of McCarren-Ferguson Act

Wendy's v State of Illinois

- Case was a challenge to Wendy's exclusion of its captive insurance company from the income tax base of the consolidated return
- Illinois tried to argue that the captive was not an insurance company under the IRC

Wendy's v State of Illinois

- Scioto was formed in VT to write a more comprehensive program for Wendy's and BI coverage
- VT required sufficient capitalization to cover all insurance obligations including CAT coverage
- Scioto acquired an affiliate of Wendy's that held Wendy's trademark

Wendy's v State of Illinois

- Scioto survived two IRS audits on the issue of whether it was an insurance company
- The acquired affiliate generated $389M in royalty income and Scioto wrote $20M in premiums
- Illinois argued that the majority of income was from royalty not insurance

Wendy's v State of Illinois

- Court held on the income issue that it was the character of the business conducted not the percentage of income that determines what a company does
- Held Scioto was licensed as a insurance company in VT and that they owned the affiliate to meet capitalization requirements

Wendy's v State of Illinois

- Therefore, the income should be excluded from the Illinois unitary return as Scioto was an insurance company.

Costco v State of Oregon

- Costco filed Oregon consolidated excise tax returns but excluded its wholly-owned captive insurance company
- Oregon challenged and concluded that the insurance company was unitary and should be included

Costco v State of Oregon

- Captive was a Bermuda entity and had made a section 953(d) election
- Captive received premiums from Costco" affiliates and reinsurance premiums from Green Island
- Captive had no connection to Oregon

Costco v State of Oregon

- The Court concluded that the Oregon unitary tax rules were applicable to the insurance company and that Costco was required to include the income of the captive in the consolidated return.

Texas Rule 3.835

- Ruling:
  - A 4.85% tax is assessed on nonadmitted Captive Insurance Companies
  - Captive insurer is defined as an insurance company that is formed for the purpose of insuring the risks of entities that are related to it through common ownership. These may be referred to as single-parent, in-house, or pure captives.
  - The taxpayer must allocate the premium using the allocation standard that most reasonably and equitably apportions the premium applicable to the risk in Texas, other states, and nontaxable jurisdictions based on the type of policy.
  - In the case of an indemnity policy that reimburses the insured for losses paid, the location of the risk or exposure insured is the location of the insured's home office.

New York

- Combinable Captive Insurance Company:

- For those Captive meeting the following criteria, they must be included in the Parent's NY income tax return and be subject to NY income tax.

- Combinable Captive insurance company means an entity that is treated as an association taxable as a corporation under the internal revenue code

(a) more than fifty percent of the voting stock of which is owned or controlled, directly or indirectly, by a single entity that is treated as an association taxable as a corporation under the internal revenue code and not exempt from federal income tax;

(b) that is licensed as a captive insurance company under the laws of this state or another jurisdiction;

(c) whose business includes providing, directly and indirectly, insurance or reinsurance covering the risks of its parent and/or members of its affiliated group; and

(d) fifty percent or less of whose gross receipts for the taxable year consist of premiums **from arrangements that constitute insurance for federal income tax purposes**.

Indiana House Enrolled Act No. 1206

- Beginning with calendar years after 2012 a **$2,500** tax is due to the treasury of Indiana for certain captive insurers:

- Captive Insurer means a foreign or alien company:

- That is supervised in the foreign or alien jurisdiction;
- That is owned by a person who conducts business in Indiana;
- Whose exclusive purpose is to insure property and casualty risks of:
  - The parent entity
  - Affiliates of the parent; or
  - Controlled unaffiliated business
- That has not more than $2,000,000 of annual direct premium