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A Brief History of the World

(Or at Least the US Captive Insurance Industry Battle with the IRS)

Gary Osborne (gosborne@usarisk.com)
President, USA Risk Group, Inc.

The Captive Industry has been around for almost 50 years and for almost that long has been fighting with the IRS in seeking to have captive insurance companies receive the favorable tax treatment allowed by the US tax code for Insurance Companies.

The normal tax treatment of business expenses are that they are deductible when **paid.** Insurance Companies get to deduct expected losses when they are **incurred**. The public interest in ensuring that insurance companies have sufficient funds in reserves to meet their future obligation to pay claims when they are settled means that insurance companies are able to deduct uncertain future commitments (subject to some discounting factors) giving them a substantial deferral of income until known claims are settled out.

Self Insured companies are not able to deduct loss reserves and Incurred But Not Reserved amounts, they can only deduct losses when they are paid. Thus if a corporation could form an insurance company that met the known rules to achieve insurance company tax treatment it could achieve a significant tax deferral benefit. The benefit is a timing issue as the insurance company treatment is allowing the acceleration of the loss deduction to year one instead of receiving the tax benefit as the claims are paid out, say over 10 years for workers compensation as an example (see callout, this page).

> ### Example
>
> If expected workers comp losses for 2014 were $10m, a captive passing muster would be able to deduct the full $10m as an expense as opposed to a self insured who would probably be able to deduct $2m in actual claims payments made in 2014. The remaining $8m in claims would be deducted from 2015 to 2024 as they were paid. The benefit of the $8m acceleration depends on Internal rates of return but actuarial firms have ball parked the benefit as between 6% to 8% or $500,000 to $650,000 annually in the above example. A simple captive would cost approximately $80,000 in operating costs and while there may be many other reasons for forming this company, the tax efficiency remains an often decisive factor in the formation of a captive. (Other reasons can include lack of markets, access to or lower cost reinsurance, profit center, policy wording flexibility, collateral relief, cost allocation tool and other insurance or business problems) ★

The IRS long held to the "economic family" argument which took the position that a captive was not acting as an insurance company when it was a controlled entity of its parent company. Their basic argument was that the captive did not meet the two basic tests for insurance of Risk Distribution and Risk Transfer.

Risk Distribution is the law of large numbers at work. The IRS believes that insurance should "spread" the risk of loss amongst "many" entities or exposures. This grey area has been the biggest battle ground for the captive industry.

Risk Transfer means that the insurance company must be able to make either a profit or a loss. The issue here has always been what constitutes a "loss". The industry for many years used a rule of thumb of a 10% chance of losing 10% (for property and casualty expo-

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Captive Insurance in Support of Mergers & Acquisitions

Dennis Silvia (dennis.silvia@cedarconsulting.net)
President, Cedar Consulting, LLC

One of the most difficult aspects of the Mergers and Acquisition process is the quantification of assets and liabilities which yield an equitable value for the business and allow the transaction to close. Often the acquirer sees assets and liabilities with a different eye than target company. This might be because the acquirer is looking for a bargain or they are truly concerned about the balance sheet value of the target. The target may defend balance sheet values because in their mind they are the most representative of the company's value position.

A captive insurance entity could help in closing a deal that has come to a dead end over valuations by isolating disputed balance sheet items. Here is an example of how it might work. ABC Company has maintained a $100,000 per occurrence deductible on its workers compensation coverage for the past 10 years. Each year they have an actuarial analysis conducted to determine the outstanding liabilities associated with the deductible. Because of good employee relationships, solid risk management protocols and an aggressive return to work policy ABC has been able to beat the actuarial projections year after year. Now a target for acquisition, the acquiring company wants to reduce the value of the company by the actuarial study high value rather than the low value that ABC ownership feels is a more reasonable reflection of liability. The difference in liability value is $3,000,000 across the 10 years that the deductible has been in place. The target company owners establish a captive insurance entity to assume all the liabilities under the various workers compensation contracts over the ten year period. This would include the payment of case reserved claims and the full amount of the disputed incurred but not reported claims. By using the actuarial high point the acquiring company is comfortable that the liabilities are being funded to their satisfaction, but by using the captive once the claims portfolio pays out over the next several years if the target company was correct in estimation of the ultimate loss cost then the captive should be holding the $3,000,000 in difference. The acquiring company paid what they thought was the right price given the liabilities they saw, the target company owner was able to close the deal for the sale and still hold on to the savings they knew was present in the actuarial range between low estimate and high estimate losses less whatever frictional cost the captive generated as the losses ran off.

A captive might also be a mechanism to provide Representation and Warranty coverages that are typically required in an M&A transaction. The acquiring company may ask for a financial guarantee that the representations made by the seller were true and complete. An insurance policy provides some limit of liability coverage to provide protection for the acquiring company should that not be the case. By taking a portion of the proceeds from the sale and buying the policy from a captive, fully funding the aggregate limit of insurance coverage the Reps and Warranties coverage is in place and when the time period expires then the premiums are returned to the target company owner by a dividend.

When done right a captive can be a powerful risk management and risk finance tool that can facilitate M&A deals that might otherwise be dead because of differences in opinion over the value of asset sand liabilities. ★

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sures). This position has been challenged but there is, to date, no clarity to this issue. Part of the issue was that some risks (e.g., workers compensation) have a long payout pattern and an insurance company could easily recoup the 10% risk margin through investment income which might call into question the captive really "making a loss".

Below is a list of some of the key court decisions that impact captive taxation:

Helvering v LeGierse, 312 U.S. 531 (1941) - this case established that both risk transfer and risk distribution are required for a contact to be treated as insurance.

Throughout the 70s and 80s the IRS held to its doctrine of the economic family and courts disallowed deductions for premiums paid to Captives in **Carnation Co v Com'r, 71 T.C 400 (1978), Stearns-Roger v Com'r., 577 F.Supp 833(d.Cob 1984)** and **Clougherty Packing Co. v Com'r., 84 T.C. 948 (1985)**

Sears, Roebuck & Co. v. Commissioner 972

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Edited by **Jacob P. Silvia** (jacob.silvia@cedarconsulting.net)

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F.2d 858 (7th Cir. 1992) took this position to an extreme. Sears paid $14m to Allstate, a wholly owned company. Allstate wrote over $5b in premiums so the Sears premiums constituted less than 0.5% of the total premium written. The IRS contended this did not meet risk transfer or risk distribution and was simply moving money between related companies. The court disagreed indicating that there was clearly risk distribution amongst numerous entities and that Allstate could suffer a loss from the Sears business.

The captive industry started to win beginning in the late 80s with a now seminal case.

Humana, Inc v Com'r 881 F.2d 247 (6th cir 1989). The 6th circuit court of appeals held that a "brother-sister" captive insurance structure constituted insurance for federal income tax purposes and thus premiums from the captives brother-sister entities were deductible. (The court held however that premium from the captive parent were not deductible). The decision was based on a "balance sheet" approach, whereby "risk shifting" is recognized if the value of a loss if transferred off of a brother sisters balance sheet to the captive.

Brother-sister refers to multiple separate legal entities. The structure in Humana was approximately 30 companies under a holding company and the holding company was the owner of the captive.

This was followed in **Kidde Industries, Inc. v U.S., 40 Fed Cl.42 (1997)** while **The Harper Group v Com'r 96 T.C 45 (1991)** found that risk transfer and risk distribution were achieved when the captive received 29 to 32% of its premiums from unrelated parties.

Amerco Inc, et al vs Com'r , 9th Cir (1992) AMERCO, Inc. and a number of its subsidiaries purchased insurance policies from Republic Western Insurance Company and deducted the premiums for income tax purposes. The insurance business from the AMERCO group constituted from between 26 percent to 48 percent of Republic's business; the remaining insurance business was unrelated. Because Republic was a subsidiary of AMERCO, the IRS determined that the transactions did not constitute "insurance" for income tax purposes, and disallowed the deductions. AMERCO petitioned the Tax Court for a redetermination and the Tax Court held that the arrangement between AMERCO and Republic constituted insurance for federal income tax purposes.

Following on from these defeats in Humana, Kidde, Harper and Amerco, the Internal Revenue Service issued three Revenue rulings in 2002.

Rev Ruling 2002-89 indicated that 50% unrelated risk qualifies as sufficient risk distribution for insurance company tax treatments.

Rev Ruling 2002-90 indicated that 12 or more subsidiary companies where no one sub comprised more than 15% of the total premium also achieved sufficient risk distribution for tax treatment as insurance

Rev Ruling 2002-91 indicated that 7 or more unrelated insureds in a group captive also achieved risk distribution and risk transfer.

There was no explanation as to why 7 entities worked for unrelated companies but it needed 12 subsidiaries to achieve risk distribution. It is worth noting that the "safe harbor" rulings are set much higher than some of the court cases discussed previously.

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From the IRS Website

Captive Insurance

Another abuse involving a legitimate tax structure involves certain small or "micro" captive insurance companies. Tax law allows businesses to create "captive" insurance companies to enable those businesses to protect against certain risks. The insured claims deductions under the tax code for premiums paid for the insurance policies while the premiums end up with the captive insurance company owned by same owners of the insured or family members.

The captive insurance company, in turn, can elect under a separate section of the tax code to be taxed only on the investment income from the pool of premiums, excluding taxable income of up to $1.2 million per year in net written premiums.

In the abusive structure, unscrupulous promoters persuade closely held entities to participate in this scheme by assisting entities to create captive insurance companies onshore or offshore, drafting organizational documents and preparing initial filings to state insurance authorities and the IRS. 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. The promoters manage the entities' captive insurance companies year after year for hefty fees, assisting taxpayers unsophisticated in insurance to continue the charade." ★

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Rent-A-Center, Inc. and Affiliated Subsidiaries, 142 T. C. I. (2014) The court held that in order to have risk distribution, the insurer needs to insure a large enough pool of unrelated risks. The Tax Court said a captive may achieve adequate risk distribution by insuring only subsidiaries within its own affiliated group. There were a sufficient number of statistically independent risks in the Rent-A-Center case given the large number of stores, employees and vehicles.

This recent decision is considered significant in that the court seemed to look at total exposure units more than number of entities in determining risk distribution and secondly it did not place much import on a intercompany loan, a fact the IRS had previously argued was evidence of a lack of risk transfer.

Most practitioners are unwilling to go out on a limb and argue that Rent-a-Center has moved the bar yet. It is still seen as prudent to look for seven or more subsidiaries or to try and find 30% or more unrelated risk if a captive owner wants to achieve tax treatment. These levels are still in the "grey" area which could be challenged by the IRS as being out with their safe harbor but are seen as very defensible based on the court cases discussed in this article.

It is also worth noting that the IRS issued proposed guidance on risk transfer and risk distribution in September 2011 which would have "looked through" to a segregated cell and each cell would then be looked at to see if it meet risk distribution and risk transfer tests as if it was a stand alone entity. There has been no follow up to this guidance but many in the cell industry have acted as if it is the expected IRS position even though it has not been formalized.

Other Federal Tax Issues

Small Insurance Company Election

There has been a huge increase in the formation of captives that write premiums below $1.2m and elect to pay tax only on their investment income under IRS code section 831 (b). The aggressive use of this vehicle by estate and tax planners has resulted in the IRS including captive insurance in their "dirty dozen" list of tax scams (see callout, prev. page).

Cascading Federal Excise Tax

Premiums ceded to insurers or reinsurers outside of the United States are subject to a 4% federal excise tax on direct premiums and 1% on reinsurance premiums. The IRS held that this tax "cascaded" and was due if an offshore company reinsured to another non US company and so on and so. This was an area of audit effort in recent years looking for foreign schemes and additional revenue. Validus Reinsurance Limited, a Bermuda company, decided to challenge this tax.

Validus filed suit in U.S. District Court challenging the IRS' determination and assessment of **tax** on the grounds that the **FET** does not apply to transactions between two non-

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USA Risk Group 10th Annual Executive Educational Conference Recap

Adam Forstot (aforstot@usarisk.com)
Vice President, USA Risk Group Managers, Inc.

USA Risk Group recently wrapped up its 10th Annual Executive Educational Conference at the Ballantyne Resort in Charlotte, NC. With more than 150 attendees, including more than 40 current and prospective captive owners, this was our biggest conference ever. Thank you to all of our clients, colleagues and friends who were able to participate in the event. A special thank you to all of our sponsors without whom the conference would not be possible.

The conference got off to a rousing start with a dynamic presentation from the Chairman of Spencer Capital, Dr Kenneth Shubin Stein. Ken gave an overview of Spencer Capital, their plans for USA Risk Group and answered some challenging questions about the economy and investment climate. A link to the presentation can be found here:

http://usarisk.com/2015-videos

The conference continued over the next two days with entertaining and informative presentations on a wide range of topics from Money Market Reform (major changes in store for 2016), actuarial insights, IRS activity, investment trends, collateral options, a lively regulator roundtable, reinsurance, issues for maturing captives, cyber security concerns, technology innovations in the insurance space (yes, that is really happening) and an update on USA Risk products and programs.

Evening activities included "glow putting" and "corn-hole" (for the uninitiated, bean bag toss) tournaments and a beer tasting courtesy of local brewery, Unknown Brewing. We also had great lunchtime activities with a performance by "extreme" juggler Paul Miller and an informative presentation on Lloyd's of London from their U.S. representative, Glenn Dorr.

For those of you who were unable to join us we hope you enjoy the video replays of the sessions and hope to see you in 2016! Mark your calendars for May 24 – 26, 2016, once again at the beautiful Ballantyne Resort in Charlotte. ★

Bermuda Captive Conference

Dennis Silvia (dennis.silvia@cedarconsulting.net)
President, Cedar Consulting, LLC

This year's Bermuda Captive Conference attracted a record number of over 800 participants, sponsors and exhibitors over 300 of which came from abroad. Bermuda continues to be the leading captive jurisdiction with over 800 captive insurance companies on its register writing $48.1 billion in premiums and reporting assets of $161.3 billion.

Stacey Hoyte, Joyce Scott, & Khia Looby at the BCC USA Risk booth. **Photo Credit** Tom McMahon.

Tom McMahon, Cedar Management Limited President and this year's Conference Chairman expressed great satisfaction with the conference, "we have had a record attendance, a record number of sponsors, a record number of exhibitors and some excellent presentations. I couldn't be more pleased".

Next year's conference is scheduled for June 13-15, 2016. ★

Tom McMahon enjoying the fireworks. **Photo Credit** Dale Fenwick.

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U.S. reinsurers that occur outside the United States. Validus also contended that the IRS lacks the power to **tax** transactions between non-U.S. parties.

The District Court ruled in favor of Validus. It noted that Validus' transactions are retrocessions and reasoned that the plain language of the statute does not impose a federal excise tax or retrocessions.

953(d) Election

In 1989, the Internal Revenue Service published Notice 89-79, which provides substantive and procedural rules regarding an election under section 953(d). Section 953(d) allows a controlled foreign corporation engaged in the insurance business to elect to be treated as a U.S. corporation for U.S. tax purposes. A controlled foreign corporation that makes this election will be subject to tax in the United States on its worldwide income but will not be subject to the branch profits tax or the branch-level interest tax imposed by section 884. Further, the federal excise tax imposed under section 4371 on policies issued by foreign insurers will not apply.

The need for a closing agreement and letter of credit to cover possible tax obligations to the US has become more contentious recently. The IRS has been using a more aggressive formula in determining required amounts as the formula says "10% of the electing corporation's gross income". When a captive wrote $1m in premium in December of (say) 2014 the IRS, in several cases, argued that the corporations gross income should be $12m ($1m in December would be held to be $12m annualized). This would require posting a Letter of Credit for $1.2m instead of $100,000. There is some thought this is being done to make life more difficult for offshore companies to take the 831b election.

Where we are today.

The captive world has had a string of court successes that today create a reasonable road map for a company to follow to achieve insurance tax treatment for a captive subsidiary. Multiple entities or sufficient unrelated risk can be structured to follow the court cases of revenue rulings and create a tax position that is strongly defensible. However, the explosion of 831b small insurance company captives has put captives back in the crosshairs of the IRS. It is clear the IRS is still looking to challenge captive insurance arrangements where it sees an operational fact pattern that is unusual for an insurance company or a fact pattern that has had questions raised in court decisions.

In fact watch out for R.V.I. Guaranty and Subsidiaries v Com'r which is being tried currently. It is addressing another unclear insurance issue – what constitutes insurance risk as opposed to business risk. This case could have major impact on many of the esoteric covers being written in some 831b captives and whether the IRS will have some court guidance as to what is business risk as opposed to insurable risk. **The fight goes on!** ★