A change in strategy

Phillip England and Randall Beckie of Anderson Kill break down how new tax rules might prompt a change in group captive insurance arrangements

We would like to share the following idea from our captive insurance advisory practice. There is more to say about it than space allows here, and you should always consult a professional tax adviser about this and potentially other captive planning ideas. We remind you that you cannot rely on a magazine article as authority for your tax interpretation. Having said that, here's the kernel of an idea that, with a bit of help, some group captives might find useful.

Group captive insurance arrangements, such as risk retention groups (RRGs) for physicians' practices, historically have left on the table the type of tax benefit that closely-held and middle-market businesses often try to qualify their captives for: namely, legitimate tax exemption. A small insurance company, including a captive, may qualify for tax exemption under one of the following provisions of the US tax code:

- Under §831(b), a non-life insurance company may exclude its net underwriting income from tax in any year for which its written premiums do not exceed $1.2m.

- Under §501(c)(15), an insurance company is altogether exempt from tax if its gross receipts do not exceed $600,000 (50%+ of which must be premiums and the remainder of which may include investment income), provided that there are (generally speaking) no other revenue-generating 'C' corporations that are commonly controlled by the owner(s) of such an insurance company.

For a group captive, the obstacle has been that premium volume generally exceeds $1.2m. However, since the IRS' issuance of Revenue Ruling 2008-8, it may be possible to structure a group captive's income to qualify for tax exemption under §831(b) or §501(c)(15) by dividing the underwriting income into pieces that are allocated back to the group's members via reinsurance to segregated cell captives that are owned by the members. Let us explain by example.

A tax-efficient group captive

Seven unrelated physician's practices form and own a RRG that writes coverage earning $700,000 of premiums from each of them, collectively pooling $4.9m of premiums. The RRG is organised as a segregated accounts company (SAC) that forms seven segregated cells. Each physician's practice is the sole participant and beneficial owner of a segregated cell. Each cell writes $500,000 of premiums directly from its participant. In addition, each cell assumes $650,000 of reinsurance premiums from the SAC's collective risk pool. In total, each cell writes $1.15m of premiums, 50.6% of which represents unrelated party risk [(6/7 X $650,000)/($650,000 + $500,000)]. Provided that qualification criteria in Revenue Rulings 2002-89, 2002-90, 2002-91 and 2008-8 are otherwise satisfied, each cell would qualify as an insurance company and furthermore is eligible for §831(b). Meanwhile, the SAC is left with $350,000 of net premiums [7 X ($700,000 - $650,000]. The SAC may use its net premium revenue to buy excess loss coverage from a commercial reinsurer and to provide administrative services (via outsourcing) to the cells.

Of course, the tax exemption that applies to the underwriting income in each cell is beneficial only in so far as the cell manages to operate at an underwriting profit. In absence of a §831(b)-based strategy, a group captive arrangement might aim to operate at breakeven. But with a §831(b)-based strategy, a group captive arrangement may want to price premiums at commercially comparable rates in anticipation of generating underwriting profits for its members.

The structural approach described above is a logical implication of the observation that in a group risk pool, each member of the group puts his premium at the risk of every other member – effectively causing the members to insure one another. Industry precedent for this structure may be found in reciprocal insurance/reinsurance interexchanges. If each member is economically insuring every other, does that mean that each member is literally an insurer? Potentially, yes – as long as each member qualifies as an insurance company itself, now feasible thanks to the Rev. Rul. 2008-8, which affords separate insurance company treatment to a cell captive. Whereas a traditional standalone captive insurance company might cost $25,000+ annually just for audit fees, licensing and corporate registration, a cell captive (especially if there is a group of them) can operate at a fraction of that cost.

The idea of making a group captive into a group of cell captives works well where each member of the group wishes to pool some risk but also retain some risk. As we have written previously in *Captive Review* (see *When the Tail Wags the Dog*, November 2008), there is nothing unseemly about optimising the tax aspects of an insurance arrangement that is driven by business reasons. In IRS' eyes, the test of legitimacy is how the non-tax reasons compare to the tax benefits. This is an objective test.

Issues raised by the proposed formation of a group of cell captives may include:

- Details of implementation: Although Rev. Rul. 2008-8 is currently authoritative as to the treatment of a cell as a separate insurance company, the IRS has not yet issued anticipated guidance regarding details of implementation, such as how to treat the participant of a cell as its owner for tax purposes notwithstanding that formal voting rights of the SAC (including the cells' operations) may belong to a sponsor.

- Separateness of cells: In order to treat a cell as a separate insurance company for tax purposes, the various cells in a group arrangement must be truly separate in economic substance and must be engaging the writing of true insurance. The IRS has authority to unwind reinsurance transactions where tax benefits are disproportional to insurance risk transfer.

- Adequate capitalisation: The SAC's capital may be allocated among cells, although the mechanism may require regulatory approval. Furthermore, a cell (as a reinsurer of the SAC) may need additional capital from its participant in order to be able to absorb the losses it assumes.

Taxation of dividends from a cell depends on who the constructive owner of the cell is. If the constructive owner is a C corporation holding company, a dividend could qualify for a 100% dividends received deduction. To an individual owner, a dividend would be taxable at the capital gains tax rate (15%) unless rates change by the time of the dividend distribution.

Too much of a good thing?

Prior to amendment in 2004, §501(c)(15) conferred tax exemption to a captive with not more than $350,000 of premiums but potentially a large amount of investment income. The 2004 amendment closed that loophole (in the wake of abuses that were profiled in *Forbes* and the *New York Times*) by imposing a $600,000 gross receipts limitation onto §501(c)(15). In the legislative history to that amendment, Congress noted that it did not perceive §831(b) to be the subject of abuse.

Some commentators have recently bemoaned the promotion of §831(b)-based strategies, speculating that by enjoying too much of a good thing, owners of §831(b) captives could spoil the opportunity for everyone. Such call for caution, although potentially prudent, is difficult to distinguish from the sound of crying 'Wolf!' Unlike the fate of §501(c)(15), to date there have been no legislative initiatives to curtail §831(b).

The legislative intent of §831(b) was simplification of complex rules under pre-1987 law. With §831(b), Congress decided to exempt small insurers, whether stock or mutual companies, from tax on underwriting income. In order to qualify a company as a small insurer, the tax statute aggregates premiums among insurance companies within the same controlled group. A group of cell captives in the example above would not be within the same controlled group. Thus, cell captives arguably could qualify under §831(b) with the same intendment that applies to traditional standalone captives, regardless of how many of them are formed at the same time. The only significant difference is that thanks to Rev. Rul. 2008-8, cell captives can be formed and administered at lower administrative cost while enjoying the same tax treatment as standalone captives. On that point, see previous articles by England and Beckie, *Now You Own It, Now You Don't: IRS clarifies taxation of rent-a-captives*, *Captive Review*, April 2008 and *Industry Comment* on Rev. Rul. 2008-8, *Captive Review*, December 2008.

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The foregoing is the tip of the iceberg amidst a potential sea change in group captive strategy. Again, the only advice we can offer here is to obtain professional assistance with the analysis, implementation and execution of this or any captive tax planning idea.

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