



CAPTIVE INSURANCE ARRANGEMENTS: WHEN ARE THEY INSURANCE FOR FEDERAL INCOME TAX PURPOSES? (PART 2)

Written By Alan J. Fine, Brian Johnson, Donna Eldridge, Kerrie Riker-Keller, Michael Teichman, and Rick Eldridge

As noted in Part 1 of this two-part series examining when captive insurance arrangements are considered a legitimate insurance structure for Federal income tax purposes (published in the October edition of the *Self-Insurer*), we examined various Tax Court decisions and IRS Revenue Rulings and other proclamations to help business owners, their advisors, tax professionals, and policymakers better understand what factors need to be present to effectively show that a captive insurance arrangement has a legitimate insurance purpose and structure.

Our focus in Part 1 was on the concepts of Exposure Units, Risk Shifting, Risk Distribution, and the Law of Large Numbers. In Part 2 of this article, we will address the subjects of Risk Pooling and the unwarranted concerns over the appearance of a circular flow of funds, including the accounting for Risk Pooling. But first, we will re-review the concept of the Law of Large Numbers.

Editors Note: This is Part 2 of a two-part article. Part 1 appeared in the October edition of the Self-Insurer.

THE LAW OF LARGE NUMBERS

As we explained in Part 1, the Law of Large Numbers is a statistical term that says the larger the sample size, the more accurate one can measure the mean and the variance thereof, thereby allowing an insurer to price the risk more accurately and hopefully less expensively. Said another way, using loss and exposure data is the ability to accurately estimate the expected losses relative to the number and type of risks insured. Hence, the larger the pool of data (i.e., sample size), the more accurate the estimates can be relative to accurate exposure data, legal climate, costs, etc.

In Revenue Ruling 2002-90, the IRS focused on the significant volume of independent, homogeneous risk, explaining that:

- [P]rofessional liability of risks of 12 operating subsidiaries are shifted to S. Further, the premiums of the operating subsidiaries, determined at arms-length, are pooled such that a loss by one operating subsidiary is borne, in substantial part, by the premiums paid by others. The 12 operating subsidiaries and S conduct themselves in all respects as would unrelated parties to a traditional insurance relationship, and S is regulated as an insurance company in each state where it does business. The narrow question presented is whether P's common ownership of the 12 operating subsidiaries and S affects the conclusion that the arrangements at issue are insurance for Federal income tax purposes. Under the facts presented, we conclude the arrangements between S and each of the 12 operating subsidiaries of S's parent constitute insurance for federal income tax purposes.

As noted in Part 1 of this two-part series, we do not know how the number 12 was derived in Revenue Ruling 2002-90. That said, in statistics, a random sample may be 12, 15, or 20 different opinions of whatever is being tested. In a captive, 12, 15 or 20 different risks with proper actuarial analysis where the pricing of risks can be compared to larger data sets available from sources such as ISO rating classes, the pricing of risk may be fairly accurate even though it is not "large" as the Court defined it in, for example, Rent-A-Center. Thus, an insured with 12 different unique risks can have an appropriate level of Risk Distribution, and the application of the Law of Large Numbers can be applied to the pricing of the risks based on individual historical performance and industry rating data for classes of business to be insured.





RISK POOLING

Most mid-sized businesses (defined here as those with revenues of between \$50 to \$250 million annually) will likely not have 12 operating subsidiaries to qualify as an insurance company for Federal income tax purposes under Revenue Ruling 2002-90. Hence it is necessary for these businesses' captive insurers to join a reinsurance pool, whereby premiums and losses are shared with other participants in order to properly distribute risk.

Risk Distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. Note that this comment is reinforcing the spread of risk, as opposed to the pricing of said risk.

Pooling is an arrangement that originated in the earliest insurance markets and is common today. One of the most well-known pooling arrangements is Lloyds of London, where underwriters subscribe to an individual risk by literally signing their name and a percentage to accept a given risk. And through the International Group of P&I Clubs, today approximately 90% of ocean-going tonnage is covered for liability risks by 12 protection and indemnity "clubs" that pool their risks through a pooling agreement.

What we don't see in the background is all the accounting and bookkeeping that takes place to account for these transactions.

Three aspects of pooling are worth mentioning:

- If an individual risk is actuarially sound, meaning it is priced adequately for the risk being assumed, then when this risk is assumed or pooled with other actuarially sound risks, it solidifies the Law of Large Numbers – two risks may be very different, but the individual pricing is adequate, and over time the losses will revert to the mean.

- Because risks and insurers are different (but actuarially sound), they can participate in a pooling arrangement where the size and complexity of the insured risks are accounted for based on the premiums. For example, if there was a pool with 10 insurers and if the exposure units were identical and the premiums therefore identical, then each member would be responsible for 10% of any covered loss. If a single member of a pool was 3 times the size of each of the other 9 single members (due to either larger exposure units and or risks with a higher probability of loss), then the larger member would be responsible for 25% of a loss, whereas the other 9 member would be responsible for 75% of the loss (or 8.3% per member = 75%/9 members).
- Pooling is beneficial to an insurer if done correctly because the pool creates risk diversification and independence, similar to the investment portfolio diversification example referenced in Part 1 of this two-part article. Pools that contain a single type of risk, such as wind or earthquake for example, may have some geographic diversity but fail to provide broad enough risk diversification unless the insurers are able to charge enough premium to be financially sustainable over time, given the premiums generally cannot sustain the losses.

Put another way, in the absence of independence, there would likely be positive correlation of risks. Positive correlation arises from common exposure among risks (frequently called “contagion risk”), such as many insured buildings being in close geographic proximity. As an example, if there was one claim for losses due to hurricane damage, there would likely be multiple claims. Positive correlation creates fluctuation and unpredictability in an insurer’s claims experience, effectively reducing risk distribution.

Negative correlation, on the other hand, would mean properties located in a geographically dispersed manner would distribute the risks and minimize claims. This is why it is difficult, even for commercial insurers, to provide catastrophic coverage in certain geographic areas (e.g., California earthquake or Florida wind, and hence why the commercial insurance market continues to reduce its exposures to accounts with wind (hurricanes) and earthquakes and hence why insureds turn to captive insurers to provide coverage and finance these risks).

THE CIRCULAR FLOW OF FUNDS AND THE ACCOUNTING THEREOF

In *Swift v. Commissioner* (“Swift”), the Court stated that it is required to determine: “whether [each] quota share arrangement was a true arrangement for the distribution of risk.” In this evaluation of *Swift*, the first topic the Court discusses is the “circular flow of funds” factor.

Insurance pools – for accounting purposes – have a circular flow of funds between the insurer and the pool (reinsurers). This occurs through ceded premiums to the pool (and its respective members) and retroceded premiums back to the insurers. Without this accounting methodology, it would be impossible to determine the economic participation of each insurer/member, as described earlier. This is directly addressed in the American Institute of Certified Public Accountants’ *Auditing and Accounting Guide*, Pursuant to Chapter 6, Paragraph 610, which provides:

- Pro rata reinsurance is a sharing, on a predetermined basis, by the insurer and reinsurer of premiums and losses on a risk, class of risks, or particular portion of the insurer’s business. For a predetermined portion of the insurer’s premium(s), the reinsurer agrees to pay a similar portion of loss and loss adjustment expenses (LAE) incurred on the business reinsured. The reinsurer’s participation in the claims is set without regard to the actual frequency and severity of claims. For example, under a 50% quota share treaty, the reinsurer receives 50% of the insurer’s premiums

and is obligated to pay 50% of each claim and claim-adjusted expense incurred by the insurer.

Furthermore, this accounting creates the mixing/diversification of risks within the pool, and ultimately back to the insurer.

A lynchpin of a reinsurance pool is what happens when there is a loss. Are claims submitted to the pool? Are members paying their proportional percentage of losses for participation? Are these claims reviewed at arm's length to protect all the pool members paying the claim? After all, there is a fiduciary responsibility on the part of the reinsurance pool manager and claim adjusters to protect members against fraud (intentional or not) and the general self-serving interest of the insurer submitting the claim.

Interestingly, the circular flow of funds referenced in the Rent-A-Center case involved the insurer (Legacy) purchasing the treasury stock of Rent-A-Center. The Court stated:

- The [IRS] contends that Legacy was not an independent fund but an accounting device. In support of this contention, [the IRS] cites a purported "circular flow of funds" through Legacy, RAC, and RAC's subsidiaries. [The IRS's] expert, however, readily acknowledged that he found no evidence of a circular flow of funds, nor have we. Legacy, with the approval of the BMA, purchased RAC treasury shares but did not resell them. Furthermore, [Rent-A-Center] established that there was nothing unusual about the manner in which premiums and claims were paid. Finally, [the IRS] contends that the netting of premiums owed to Legacy during 2003 is evidence that Legacy was a sham. We disagree. This netting was simply a bookkeeping measure performed as an administrative convenience. Further, there seems to be confusion as to what constitutes a "circular flow of funds" when considering the tax posture of a captive insurance company. In FSA 199945009, the IRS National Office chose to concede a captive insurance case in which "a significant portion of the premiums paid...to C were borrowed by H, thereby raising concerns about circular flows of cash."

In other situations, however, "circular flows of funds" has been used to describe the mechanism by which participants in an insurance pool exchange those risks in order to distribute those risks amongst all of the participants, which is not only prudent, but also necessary for the viability of the reinsurance pool's financial health, regardless of the tax consequences associated with doing so. Further, these flows of funds are the only mechanism for distributing risk in a pooled arrangement.

What seems to be missing in the Rent-A-Center opinion and the discussion of the "circular flow of funds" is the following question: Are funds from the insurance company being circulated back to the insured (as opposed to other insurers/reinsurers as illustrated by the accounting principles referenced above) for other reasons than a claim payment, policy dividend, or qualified loan? If so, there very well could be a "circular flow of funds," and the facts are necessary to determine if the transaction has moved beyond what is common in the notion of insurance.

CLOSING REMARKS

Outside of the tax world, the concepts around what constitutes valid insurance and reinsurance arrangements are anything but simple. For the past 5 decades, the IRS has taken it upon itself to define what does not constitute insurance (and reinsurance) for Federal income tax purposes. To date, the only current guidance for owners of captives (particularly those who have availed themselves of the election under Section 831(b)) is to not follow the examples set by the taxpayers in the cases decided by the Tax Court.



The authors developed Part 1 and Part II of this two-part article with the intent to help educate business owners, tax professionals, and policymakers as to the particular concepts that are critical to that of an insurance arrangement. This is of great importance given that there are presently in excess of 1,000 captive insurance cases pending in Tax Court. Given the behavior of the commercial insurance marketplace, we can unequivocally say that the market for captives and, specifically, for 831(b) captives has become a critical component of the risk management strategy for an untold number of businesses. Captives are here to stay, and as the business world continues to evolve, captives will help businesses insure new risks efficiently and offer flexibility that the commercial markets lack.

Citations for the Tax Court cases noted in this article, along with any other related information, can be provided to you by contacting the authors below. ■

About the Authors

Alan J. Fine, CPA, JD, Tax Partner at Armanino LLP; Brian Johnson, ACAS, MAAA, ARM, Managing Director of Risk International Actuarial Consulting; Donna Eldridge, CPA, Chief Financial Officer of The Intuitive Companies; Kerrie Riker-Keller, Chief Compliance Officer of The Intuitive Companies; Michael W. Teichman, JD, Director at Parkowski, Guerke & Swayze, P.A.; Rick J. Eldridge, President & CEO of The Intuitive Companies