Chief Counsel Advice concludes that a captive insurer's excess loss policies are not insurance

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In brief

In Chief Counsel Advice (CCA) 201533011, the IRS concluded that excess loss policies issued by a captive insurance company did not constitute insurance for federal tax purposes because the policies lacked risk shifting and were not insurance in its commonly accepted sense.

In detail

Taxpayer was licensed with the State Division of Insurance to operate as a pure captive insurance company. Entities 1-6 and Administrator (the "Group Entities") provide healthcare services to members of unrelated health maintenance organizations. Individual owns all the stock of Taxpayer and the Group Entities.

Taxpayer issued 10-year excess loss policies to the Group Entities. Premiums were due in 10 equal annual installments and each policy covered a Group Entity's costs to the extent they exceeded a specific amount, referred to as the attachment point. The attachment point was yet to be determined at the time the policies were executed, meaning the premiums were priced and the policies were executed before the attachment point was established. All claims were payable at the end of the policy term.

Taxpayer's potential liability under the policies was first capped at 150 percent of the premiums that each Group Entity paid. Later this cap was raised to 170 percent, but the Group Entities did not pay additional premiums for the increased Policy Cap. According to the IRS, the Group Entities' claims were expected to exceed the newly raised Policy Cap when the cap was raised.

To determine whether the policies constituted insurance for federal tax purposes the IRS applied the three-prong test set forth in *Amerco, Inc. v. Commissioner*, 96 T.C. 18 (1991), aff'd 979 F.2d 162 (9th Cir. 1992). Under that test, to qualify as insurance there must be (i) an insurance risk, (ii) risk shifting and risk distribution, and (iii) insurance in its commonly accepted sense. The IRS determined that the policies did not constitute insurance contracts as they lacked risk shifting and were not insurance in its commonly accepted sense.

The IRS examined the substance of the arrangements and reasoned that the risk of loss was not shifted from the Group Entities to Taxpayer since Taxpayer could expect to pay 170 percent of the premiums. As a result, risk was not shifted to Taxpayer as the losses were expected to exceed the Policy Cap, according to the IRS, and Taxpayer assumed only an investment risk; the arrangement was at best a prefunding of future expenses.

Further, the IRS cited Rev. Rul. 89-96, 89-2 C.B. 114, and Rev. Rul. 2007-47, 2007-2 C.B. 127 to determine that the policies were not insurance in its commonly accepted sense. Instead the policies were Taxpayer's prefunding of future claims it would have to pay out. Taxpayer assumed only an investment risk, namely that the premiums received would grow over 10 years by 70 percent, which is all that it promised to pay the Group Entities.

Additionally, the IRS determined that the premiums could not have been actuarially determined because they were priced before the attachment point was set and the Policy Cap was raised without increasing the premiums.

Because the excess loss policies did not qualify as insurance, the IRS concluded that Taxpayer must report income from the premiums when they are due or paid, whichever happens first, but may not deduct liabilities from claims until those claims are paid.

The takeaway

Although not precedent, the CCA provides an example of an arrangement with a captive insurance company that the IRS determined did not qualify as insurance for federal tax purposes. This outcome is not surprising based on the IRS's factual determination that the Policy Cap was certain to be reached. What is surprising is the IRS's prescribed accounting treatment. According to the CCA, the substance of the policies appeared to be more like a debt or pre-funding. Ordinarily, the recipient of such a deposit would not include that amount in income. Yet, the CCA required the inclusion of deposit amounts in income, creating a potential mismatch between the timing of income inclusion and the timing of related deductions. Several revenue rulings, which carry more weight than a CCA, instead encourage taxpayers to characterize a failed insurance arrangement according to its substance. See Arthur Scherbel and Mark Smith, "If It's Not Insurance, What Is It?" Tax Notes, March 2014, p. 359.

The CCA further raises questions as to the IRS' approach to captive insurance issues after recent taxpayer-favorable judicial authorities in *Rent-A-Center v. Commissioner*, 142 T.C. 1 (January 14, 2014) and *Securitas v. Commissioner,* T.C. Memo 2014-225 (October 29, 2014). Together with a recent IRS decision not to rule on a captive insurance arrangement involving retiree medical benefits (PMTA 2015-013), inclusion of captive insurance in the 2015-2016 Priority Guidance Plan, and the inclusion of Section 831(b) captive insurance companies in the 2015 "Dirty Dozen" list, the CCA demonstrates that the IRS is taking a cautious approach to captive insurance issues generally.

Let's talk

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