

New York State Department of Taxation and Finance



*Presented by :
Cristin Lentlie*



*Tax Treatment of Overcapitalized
Captive Insurance Companies
TSB-M-09(9)C*

- For TYBOA 1/1/2009 an overcapitalized captive insurance corporation is required to file a NY combined return (under Article 32 or 9-A) with its closest controlling stockholder.



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- Closest controlling stockholder is a corporation that:
 - Directly/indirectly owns or controls over 50% of the voting stock of an overcapitalized captive;
 - Is subject to tax under Article 9-A or 32 or is otherwise required to be included in a combined return under Article 9-A or 32; and
 - Is the fewest tiers away in the ownership structure.



Tax Treatment of Overcapitalized Captive Insurance Companies TSB-M-09(9)C

- An overcapitalized captive insurance company is a company that:
 - More than 50% of its voting stock is owned/controlled directly/indirectly by a corporation;
 - Licensed as a captive insurance company under the laws of New York State or another jurisdiction;
 - Business includes providing, directly and indirectly, insurance or reinsurance covering the risks of its parent and/or members of its affiliated group; and
 - Does not meet the principally engaged test.



Tax Treatment of Overcapitalized Captive Insurance Companies TSB-M-09(9)C

- Principally Engaged Test:
 - More than 50% of its gross receipts for the taxable year consist of premiums.
 - Premiums has the same meaning as that term is given in NYS Insurance tax law, *except* that it includes consideration for annuity contracts and *excludes* any part of the consideration for insurance, reinsurance, or annuity contracts that do not provide “*bona fide*” insurance, reinsurance, or annuity benefits.



Critical Factors in Examining the Existence of “Bona Fide Insurance”

Helvering v. Le Gierse, 312 U.S. 531, 539 (1941)

- *Risk shifting* requires that a risk pass away from the insured to insurer.
- *Risk distribution* requires spreading of losses among the insureds and providing the captive with a pool of premiums to pay losses.
- Insurance risk is present, not merely investment risk;
 - IRS makes a distinction between:
 - Insurance risk where fortuity exists
 - Business/investment risk where there is no uncertainty of loss



Critical Factors in Examining the Existence of “Bona Fide Insurance”

- Insurance risk involves uncertainties about both:
 - The ultimate amount of net cash flows from premiums, commissions and claims (underwriting risk), and
 - The timing of the receipt and payment of those cash flows (timing risk).
- Insurance risk is fortuitous
 - The possibility of adverse events occurring is outside the control of the insured.



Critical Factors in Examining the Existence of “Bona Fide Insurance”

Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985)

- Premiums paid by Parent Corp to Captive Sub.
- Determined that the parent company's assets were diminished by any casualty loss recognized.
- Therefore, the economic reality was that the risk of loss did not leave the parent company.
- Parent's premiums did not constitute insurance following Le Gierse because the parent did not shift its risk of loss (outside of the “economic family”).



Critical Factors in Examining the Existence of “Bona Fide Insurance”

Humana Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989)

- Premiums paid to Captive for risk of Parent
- Parent's premiums did not constitute insurance
- However, brother/sister premiums did constitute insurance:
 - *Risk transfer* when captive paid a claim, the assets of the subs were not affected and, therefore risk transferred from insured to insurer.
 - *Risk distribution* since several corporations were insured and losses could be spread among brother/sister companies.



Critical Factors in Examining the Existence of “Bona Fide Insurance”

Brother-Sister Balance Sheet Theory (Rev. Ruling 2002-90)

- Risk shifting and risk distribution exist when:
 - Captive insures 12 domestic brother/sister subs
 - “*Insurance*” if *each* subsidiary’s risk/premium accounted for:
 - At least 5%, and
 - No more than 15% of the total risk/premium.



Critical Factors in Examining the Existence of “Bona Fide Insurance”

Fortuity

(Revenue Ruling 2007-47)

- Nuclear power plant clean up cost.
- Remediation was 100% certain
 - Only uncertainty was scope, cost and timing
 - PV of estimated cost = \$150x
- Taxpayer purchased policy from unrelated insurer for \$150x with limit of \$300x.
- Determined to be a prefunding (deposit) of future obligations.
 - Since loss was certain to occur, IRS held there could be no insurance risk without “*fortuity*”.



Critical Factors in Examining the Existence of “Bona Fide Insurance”

- Risk must be an insurance risk, not a investment/business risk.
- Rev. Rul. 68-27, 1968-1 C.B. 315
 - Organization issued medical service contracts to groups of individuals and furnished direct medical services to the subscribers by means of a salaried staff of doctors.
 - Although an element of risk existed it was not considered to be insurance risk, but a normal business risk of an organization engaged in furnishing medical services on a fixed price basis.



Critical Factors in Examining the Existence of “Bona Fide Insurance”

3RD Party Insurance Risk

Sears Roebuck, 972 F.2d 858 (1992)

- Subsidiary insurer, Allstate Insurance Co. was a wholly-owned subsidiary insurer of Sears, Roebuck and Co.
 - licensed in 40 states.
- Subsidiary insured 10-15 % of the parent's risk
 - However, parent's premiums only represented 0.25 % of premiums earned by Allstate.
 - Other 99.75% were from unrelated policyholders.



Critical Factors in Examining the Existence of “Bona Fide Insurance”

3RD Party Insurance Risk

Sears Roebuck, 972 F.2d 858 (1992)

- The Tax Court concluded that payments by Sears to subsidiary constituted insurance.
 - Claims involved (which related to injuries to persons on the parent's premises or by the parent's vehicles) established the presence of insurance risk.
 - Risk shifting existed in both form and substance.
 - Insurance in the commonly accepted sense.



Critical Factors in Examining the Existence of “Bona Fide Insurance”

Unrelated 3rd Party Risk (Rev. Ruling 2002-89)

- Not “insurance” if 90% of risks/premiums come from the parent.
- Insurance if less than 50% risk/premiums come from the parent and the remainder are from unrelated parties.



Any questions

