A&H Captive Taxation: Opportunities and Obstacles

Accident & Health (A&H) Captives are at the crossroads of competing considerations:

• Desire to fund the A&H exposure
• Desire to fund efficiently
• Variable and rising health care costs
• Patient Protection and Affordable Care Act
• State mandates for traditional insured products
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• Design features: cancellable vs. non-cancellable
• Guaranteed renewable vs. not
• Amount, if any, of employee contribution
• Legal need/desire for fronted programs
• Tax considerations and consequences
• Third-party insurance
• Group programs

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• ERISA - Prohibited Transactions
• Need/desire for domestic domicile or branch
• 162(m)(6) effective 1/1/13
To have insurance for tax purposes, Courts have talked in these terms:

• Common notions of insurance
• Insurance risk
• Risk transfer
• Risk distribution - most contentious today
  – IRS definition vs. taxpayer definition
  – IRS self-serving guidance vs. pending court cases

After losing various court cases, IRS now agrees risk distribution may take the form of:
1) Brother-sister insurance; or
2) Enough outside (i.e., unrelated/third party) business
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“Brother-Sister” Insurance

- There is risk distribution where a captive sells insurance to enough operating subsidiaries (who own no stock in the captive).
- Rev. Rul. 2002-90 states that if there are 12 subsidiaries all with between 5% and 15% of the risks, there is insurance.
- Rev. Rul. 2005-40 states that when there is only one insured (or 2 with one having 90% of the risk), there is no insurance, even in an unrelated context.
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Outside Insurance

Parent

100% Insurance

100% Operating Subsidiaries

Insurance Subsidiary

Unrelated Insureds

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Enough Outside Business:

Parent insurance has risk distribution if the insurance company insured sufficient unrelated business:

1) The IRS says 50% is enough and 10% is not enough
2) Harper Group case says 30% is enough

In today’s tax audit environment, meeting the “safe harbor” of 50% unrelated business will likely produce fewer questions than 30% unrelated business

The IRS has asked whether it matters if the related and unrelated business are the same type of coverage (i.e., same line of business) – called the “homogeneity” issue
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Initial building blocks (discussed below) in the discussion of A&H in captives from a tax standpoint:
• Rev. Rul. 92-93
• Haynes (1957 U.S. Supreme Court decision)

Rev. Rul. 92-93
• Public company (X), a manufacturer, purchased $100,000 of non-participating group term life for its employees, from its captive
• Employer paid all the premiums
• Employee was beneficiary; Employer received no proceeds
• There was never any cash value
• Captive is a licensed insurance company that regularly sells to the public
• Under the then-existing IRS positions, if the risk shifted had been that of (X) rather than the employees, the arrangement would not have qualified as insurance for federal tax purposes
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• The IRS ruled that the risks insured were those of the employee (not employer)
• The cost is income to the employee, subject to the exclusion of $50,000 of coverage under IRC Section 79
• The premiums are deductible by (X) as compensation (if total compensation is reasonable)
• Importantly, this Ruling stated that its holding would also apply to A&H insurance – income to the employee (unless excluded) and deductible by the employer

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• IRS will not follow its victory in the Gulf Oil case and, instead, will allow a deduction by the employer for waiver of premium coverage upon disability
• The constructive compensation approach is consistent with:
  ▪ Treasury regulations
  ▪ Legislative history to the 1954 Internal Revenue Code
  ▪ Haynes (U.S. Supreme Court case)
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Haynes – 1957 U.S. Supreme Court case:
• Southern Bell offered “Plan for Employees’ Pension, Disability Benefits and Death Benefits”
• Haynes received the maximum on account of disability
• Haynes treated payments as excludable from gross income as “amounts received through accident or health insurance . . . as compensation for personal injuries or sickness”

– IRS argued that program was not insurance because:
  – Employee did not pay premiums
  – There was no disability fund and duration of benefits varied with length of service

– Supreme Court ruled that the program was health insurance
  – There was no requirement that health insurance have any of the indicia the IRS asserted
  – The employer’s program did not have to mirror commercial insurance and IRS had not been consistent in the past in interpreting “health insurance” narrowly
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• Under ERISA, the captive cannot issue 50% or more of its insurance (including ED plan coverage) with its parent and its affiliates, because of the “prohibited transaction” rules (see PTE 79-41) – i.e., self-dealing subject to penalties without a specific DOL exemption

• The DOL has required for individual exemptions that the captive be either a domestic reinsurance captive or branch and that “fronting” carriers be Best A-rated carriers

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• The DOL has also required that the employer provide some greater benefit to the employees than before the new arrangement (i.e., a sweetener)

• The DOL also requires, among many other requirements, an independent fiduciary

• After two exemptions are granted on the same fact pattern, an Ex Pro (“fast track”) approach can be used

• The DOL has issued about 30 exemptions to such prohibited transactions for about 30 large companies
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- But because the DOL official in this area recently retired, these Ex PRO exemptions have ground to a halt.
- However, if the captive writes self insured medical stop loss coverage and the employer pays the full cost of the medical coverage (i.e., no employee contributions) and the policy meets other requirements listed in the DOL Advisory Opinion 92-02A, then it is not a prohibited transaction.

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- Many have interpreted AO 92-02A as a conclusion that the risk being an insured in a stop loss policy is that of the employer not the employee.
- Many predict that the IRS will conclude that stop loss insurance is related (not third-party) insurance because it insures the employer’s risk not the employee’s risk.
Agencies Seek Comments on Use of Medical Stop Loss Insurance

- IRS, Dept. of Labor, and Dept. of Health and Human Services: Requested information about use of stop loss insurance by group health plans and their sponsors

- In 2011, DOL reported 6 of 10 private and public sector workers covered by employer-provided health care were under a self-insured plan

- How common is use of stop loss in self insured?
- What are common attachment points and factors used to determine them?
- Are employee-level or group-level points more common?
- How do insurers work with small employers to integrate stop loss?
- What are administrative costs?
- Is stop loss more common in certain industries or sectors?
- What type of entities issue stop loss?
- How do states regulate it?
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• The 2011-2012 IRS Priority Guidance Plan lists as an upcoming project needing guidance:

“Revenue Ruling under § 801 addressing the application of Rev. Rul. 2005-40 or Rev. Rul. 92-93 to health insurance arrangements that are sponsored by a single employer”

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IRS 2011-2012 Business Plan – Employee Benefits
As noted previously:
• Rev. Rul. 2005-40 ruled that insurance does not exist if the insurance captive insures only one insured (or two insureds, if one of the insureds represents 90% of the risks)
• Rev. Rul. 92-93 ruled that employee health insurance is third-party business to the employer’s captive
What are we missing? Tax benefits of A&H captive insurance arrangements for large employers:

1. Deduction for unearned premium reserves
2. Premium stabilization reserves
3. Medical inflation reserves
4. Guaranteed renewable A&H contract reserves
5. Retiree medical reserves
6. Annuity reserves
7. State tax saving as Parent transfers profit to captive
8. Constructive third party risk, hence risk distribution

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Contract or Additional Reserve (a.k.a. Active Lives Reserve)

Guaranteed Renewable A&H Insurance for Closed Block of 200 Employees

Policy Year

Tax benefits of closely-held A&H captives:

9. § 831(b) exclusion
10. § 806 Small life insurance company deduction
11. Source of third party risk via a reinsurance pool
12. Family wealth transfer planning
13. Insure family members’ disability/accident/life risk
14. Also do what large employers can do

Traditional Group A&H captives do none of the above.
831(b) Medical Stop Loss Captive

Captive insurance premium may be in the range from $1 to $250,000 (say $150k)

Captive insures employer’s SIR between 100% - 125% of expected losses

Commercial stop loss premium is unaffected by captive insurance arrangement.

Employer self-insures expected medical costs of $1.0 million

Captive’s underwriting profit is by definition “expected,” yet volatile.

Profitability and tax benefit (here, $50k) depends on premium pricing methodology.

Commercial Health Insurer covers aggregate loss in excess of $1.25 million

Captive’s underwriting profit is by definition “expected,” yet volatile.

Profitability and tax benefit (here, $50k) depends on premium pricing methodology.

Coca Cola captive
Retiree medical obligation is funded in a VEBA.

DOL PTE requires fronting ($$$).

IRS not yet saying whether stop loss attachment point conflicts with “health” insurance character.

Risk is legally unrelated party risk.

Tax advantage = 3rd party risk.

Un-cola captive
Retiree medical obligation is an unfunded budget risk of the employer.

Unfronted; captive insures the employer.

Rely on interpretation that “health” insurance character is based on origin of claim.

Risk is constructively unrelated party risk.

Tax advantage = conservatively valued reserves as well as arguably 3rd party risk.
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Is stop loss “health insurance”?

• Texas Dept. of Ins. v. American National Ins. Co (5/18/2012), citing


• Distinguishing Brown v. Granatelli

The Unrequited Ruling

PLR request sought to confirm:
• Deductibility of contract reserves for a guaranteed renewable A&H policy issued directly to affiliated employers
  – Level premium structure
  – Non-portable if employment terminates
  – Individual stop loss attachment point of $7,500
  – Quota share policy covers only employer’s budget risk
The Unrequited Ruling (continued)

PLR request also sought to confirm:

- Deductibility of captive’s premium stabilization reserves
- Deferral of insured’s return premium recognition
- Deductibility of premium payment via 12-month rule
- Characterization of insurance premium as constructive compensation such that risk is constructive 3rd party risk
- Constructive compensation is not deferred compensation

Constructive Compensation
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Unpublished feedback

• IRS said it was willing to characterize arrangement as “health insurance” if redesigned to cover first-dollar risk.

• Section 419 is generally inapplicable to health insurance premiums
  – provided that there is significant risk transfer among multiple insureds
  – no controlled group rule

• Rev. Rul. 73-475
  – Guaranteed renewable A&H does not require employees to have privity of contract
  – IRS was adverse regarding genuineness of the guaranty of renewability
  – IRS view echoes the economic family theory
  – If you want tax treatment like Aetna, you need to be subject to regulation like Aetna

Unpublished feedback, continued

• Premium stabilization reserve is part guaranteed renewable A&H contract reserve
  – IRS: a tax opinion would explain this, hence a PLR request is less than necessary
  – However, guidance is thin
  – IRS rejected the PLR request before addressing the applicable issues of interpretation

• Guaranteed renewable under § 816 can be nonguaranteed under § 419
  – Did not reach this issue because IRS rejected the notion of guaranty between related parties

• A&H risk as constructively unrelated party risk
  – IRS declined to address this issue in a PLR, based on intention to make a formal guidance project
  – Risk distribution arose from brother-sister structure instead
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Unpublished feedback, continued

• IRS: Obviously it is “health” insurance; but we can’t rule on the obvious lest tax advisers read more into it.

• “Not in the interest of sound tax administration to issue a ruling at this time.” Because perhaps the Rent-a-Center case will reveal whether IRS’ positions on risk distribution are over-stringent?

• IRS may have seen the requested points of ruling as intertwined; a PLR would jump the gun on a pending Rev. Rul.; also, Supreme Court case was pending.

• IRS: “We can’t just whisper it in your ear.” Or did they?

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Definitional characteristics of an A&H “plan”

• For tax § 106: Intention to compensate.

• For ERISA: employee ownership of rights
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Insurance tax regulations vs. § 106 and Haynes

• Reg. § 1.801-1(b): A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer.

• The 1969 Tax Act and subsequent regulations excluded a VEBA from the foregoing definition of an insurance company.

• Is an A&H plan an insurance company as long as it is not a VEBA and is not merely a fund set aside by the employer?

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• In May, the head of the IRS National Office Insurance Branch said that she anticipated that a Revenue Ruling would be issued “soon”

• It is unclear what issue(s) the Revenue Ruling will address:
  ▪ Whether employer stop loss is “health insurance”?
  ▪ What makes health insurance risk unrelated business?
  ▪ Whether Rev. Rul. 92-93 will be revoked or clarified?
  ▪ Whether it matters if the insured is the employer or a plan?
  ▪ Whether it matters if the plan is fronted by a commercial insurer?