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July 28, 2014 www.groom.com

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IRS Captive Insurance Ruling Creates Opportunities for Plan Sponsors

Recent IRS Revenue Ruling 2014-15 provides much needed guidance for sponsors of self-insured retiree medical plans who are interested in de-risking and taking advantage of their captive insurance companies to reduce the potential cost of doing so. *See* Rev. Rul. 2014-15, 2014-24 I.R.B. 1095. Under the arrangement in Revenue Ruling 2014-15, a retiree medical plan sponsor's wholly-owned subsidiary reinsured a noncancellable accident and health policy covering retirees and their dependents that was purchased by a voluntary employees' beneficiary association described in Code section 501(c)(9) ("VEBA"). The Internal Revenue Service (the "Service") held that such reinsurance constituted "insurance," including for purposes of determining whether the retiree medical plan sponsor's wholly-owned subsidiary qualifies as an insurance company under Subchapter L. Plan sponsors using substantially the same structure for funding retiree medical benefits may generally rely upon Revenue Ruling 2014-15 for purposes of determining whether such reinsurance constitutes insurance and whether their captive insurer will qualify as an insurance company under Subchapter L. Revenue Ruling 2014-15 also reaffirms the general principle that, depending on the particular structure of an employee benefit arrangement, the "insured" may be the plan sponsor's employees and their dependents, and not necessarily the plan sponsor or a plan trust.

Background

Definition of "Insurance"

Whether an arrangement satisfies the definition of "insurance" for federal income tax purposes will, in turn, affect whether (1) the issuer satisfies the definition of "insurance company," and (2) payments to the issuer are deductible as insurance premiums under Code section 162, among other federal income tax consequences. *See* Code § 816(a) (definition of "insurance company"); Treas. Reg. § 1.162-1(a). If an arrangement cannot be characterized as insurance, it creates uncertainty as to how, based on the facts and circumstances, the arrangement might be treated for federal income tax purposes. *See* Rev. Rul. 2005-40, 2005-2 C.B. 4 ("an arrangement that purports to be an insurance contract...may instead be characterized as a deposit arrangement, a loan, a contribution to capital (to the extent of net value, if any), an indemnity arrangement that is not an insurance contract, or otherwise, based on the substance of the arrangement....").

Despite the importance of whether an arrangement qualifies as insurance, the Code and Treasury Regulations are silent regarding the definition of "insurance." However, "[h]istorically and commonly insurance involves risk-shifting and risk-distributing" and presumably "Congress used the word 'insurance' in its commonly accepted sense." Helvering v. Le Gierse, 312 U.S. 531, pp 539-540 (1941).

Risk-shifting has been described as transferring the "impact of a potential loss from the insured to the insurer," and risk-distributing as "[i]nsuring many independent risks in return for numerous premiums" so that "the insurer smoothes out losses to match more closely its receipt of premiums." Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). As described in further detail below, the Service has provided guidance in the form of revenue rulings as to whether certain arrangements have the requisite risk-shifting and risk-distributing to be classified as insurance for federal income tax purposes.

Prior Revenue Rulings

In Revenue Ruling 92-93, the Service determined that the risks being shifted were those of the employees and their beneficiaries, rather than the employer, where an employer purchased group-term life insurance covering its employees from its wholly-owned insurance subsidiary, which also issued life insurance and annuity contracts to the general public.[1] The employer was not directly or indirectly a beneficiary under the group-term life insurance contract and benefits under the group-term life insurance contract were payable to the employees' beneficiaries, thus providing an economic benefit to employees. On these facts, the Service held that the $50,000 exclusion under Code section 79 was applicable and premiums paid by the employer to its wholly-owned subsidiary under the group-term life insurance contract could be deducted under Code section 162 to the extent that the total amount of compensation with respect to each employee was reasonable. The Service noted that the holdings would also apply to accident and health insurance.[2] *See* Rev. Rul. 92-93, 1992-2 C.B. 45 (*modified by* Rev. Rul. 2001-31, 2001-1 CB 1348).

In Revenue Ruling 2002-89, the Service determined that there was insufficient risk-shifting and risk-distributing where a wholly-owned subsidiary insured or reinsured the professional liability risks of its parent and, although the subsidiary also insured or reinsured the professional liability risks of unrelated entities, the arrangement between the parent and subsidiary accounted for 90% of the total premiums earned by the subsidiary for the taxable year and 90% of the total risks assumed by the subsidiary. Therefore, the arrangement between the parent and subsidiary was not considered insurance for federal income tax purposes, and payments made under the arrangement by the parent to the subsidiary were not deductible as insurance premiums under Code section 162. However, the Service also determined that there would be sufficient risk-shifting and risk-distributing where premiums under the arrangement between the parent and subsidiary account for less than 50% of the total premiums earned by the subsidiary for the taxable year and less than 50% of the risks assumed by the subsidiary. Such an arrangement would be considered insurance for federal income tax purposes and payments made under the arrangement by the parent to the subsidiary would be deductible as insurance premiums under Code section 162. *See* Rev. Rul. 2002-89, 2002-2 C.B. 984.

In Revenue Ruling 2005-40, the Service determined that risk was not distributed where Corporation X provided courier transport services and entered into an arrangement with unrelated Corporation Y to "insure" against liabilities that might arise from the operation of Corporation X's vehicles during the conduct of its business, and Corporation Y did not "insure" any other entity. The Service stated that although Corporation X may have shifted its

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[1] Determining that the risks being shifted were those of the employees was crucial because, at the time that Revenue Ruling 92-93 was issued, the Service was following the generally unfavorable "economic family" doctrine, under which "the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented one 'economic family' for purposes of analyzing whether transactions involved sufficient risk shifting and risk distribution to constitute insurance for federal income tax purposes." *See* Rev. Rul. 2001-31, 2001-1 CB 1348.

[2] The Service applied the same analysis in Revenue Ruling 92-93 to an arrangement in which an insurance company charged itself for assumption of risk for insurance and annuities benefitting its own employees. *See* Rev. Rul. 92-94, 1992-2 C.B. 144.

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risks to Corporation Y, Corporation X's risks were not "distributed among other insureds or policyholders." Therefore, the arrangement between Corporations X and Y was not considered insurance for federal income tax purposes.[3] *See* Rev. Rul. 2005-40, 2005-2 C.B. 4.

Revenue Ruling 2014-15

The subject of Revenue Ruling 2014-15 was an arrangement in which (1) a retiree medical plan sponsor made a contribution to its VEBA to fund plan benefits,[4] (2) the VEBA purchased a noncancellable accident and health policy (the "Policy") from an unrelated life insurance company (*i.e.*, the fronting insurance company) that reimbursed the VEBA for medical claims incurred by the covered retirees and dependents,[5] and (3) a wholly-owned subsidiary ("Subsidiary") of the retiree medical plan sponsor (*i.e.*, the captive insurance company) reinsured 100% of the liabilities under the Policy.

At the time that the Policy became effective, neither the plan sponsor nor the VEBA were obligated to provide health benefits to retirees and their dependents and the plan sponsor and VEBA could cancel such coverage at any time. The reinsurance agreement between the unrelated life insurance company and the plan sponsor's Subsidiary, which was subject to state regulation as an insurance company, was an arm's length agreement that represented the Subsidiary's sole business.

The plan sponsor's and VEBA's ability to cancel retiree medical coverage at the time that the Policy became effective was critical to the Service's analysis. Because the plan sponsor and VEBA could cancel retiree medical coverage, and such coverage provided an economic benefit to retirees and their dependents, the Service concluded that the risks being shifted were the personal accident and health risks of covered retirees and their dependents, rather than any risks of the retiree medical plan sponsor or VEBA. Therefore, the Service was able to determine that the risks being reinsured were distributed among a sufficiently large population and the Service was able to distinguish this arrangement from those of Revenue Rulings 2002-89 and 2005-40.[6]

Based on these facts, the Service held that reinsurance of the Policy constituted "insurance." An "insurance company" is defined as "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." Code § 816(a).

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[3] This was the case even if Corporation Y also entered into a similar arrangement with Corporation Z, which was unrelated to Corporation X or Y, and such arrangement constituted 10% of Corporation Y's total amounts earned during the taxable year and 10% of the total risks Corporation Y assumed. Likewise, there was insufficient risk-distribution even if Corporation X structured its business so that it was the single member of 12 limited liability companies ("LLCs"), unless the LLCs elected to be classified as associations for federal income tax purposes so that they were not disregarded entities. *See* Rev. Rul. 2005-40, 2005-2 C.B. 4.

[4] Code sections 419 and 419A control the deductibility of a contribution to a VEBA for retiree medical benefits. Revenue Ruling 2014-15 states that the retiree medical plan sponsor deducted the VEBA contribution to the extent permitted by Code sections 419 and 419A, but Revenue Ruling 2014-15 does not address the deductibility of the VEBA contribution. The deduction limits for the funding of post-retirement medical benefits were squarely addressed in *Wells Fargo & Co. v. Commissioner*, 120 T.C. 69 (2003). *Wells Fargo* held that a contribution that funded a reserve for the present value of post-retirement medical benefits for employees retired at the time of funding was within the Code section 419A account limits and therefore was deductible in the year the contribution was made.

[5] Revenue Ruling 2014-15 notes that participation by the unrelated life insurance company was a condition of a prohibited transaction exemption from the Department of Labor.

[6] Although not specifically stated in Revenue Ruling 2014-15, with respect to reinsurance, it is possible to "look through" a single reinsurance contract and determine risk distribution based on the number of underlying policy holders whose coverage is being reinsured. *See* Rev. Rul. 2009-26, 2009-38 I.R.B. 366.

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Because reinsurance of the Policy was the sole business of the Subsidiary, which is subject to state regulation as an insurance company, such business constituted more than half of the business of the Subsidiary during the taxable year. Accordingly, the Service also held that the Subsidiary satisfied the definition of an "insurance company" under Subchapter L for the taxable year.

Observations

The insurance arrangement described in Revenue Ruling 2014-15 provided several important benefits to the retiree medical plan sponsor and to retirees and their dependents. The VEBA's purchase of the Policy provided significant additional security to covered retirees and their dependents because it assured the payment of claims covered by the Policy regardless of the assets available in the VEBA or the fate of the retiree medical plan sponsor. Reinsurance of the Policy by the parent's Subsidiary also reduced the cost of purchasing the Policy for the VEBA and, accordingly, the necessary contribution by the retiree medical plan sponsor to the VEBA. Further, although the retiree medical plan sponsor was under no obligation to provide future retiree medical benefits, this arrangement also served as a "de-risking" strategy for the plan sponsor. To the extent that claims would be paid by the Policy, the plan sponsor would no longer be subject to the risk of large claims or medical inflation.

Many retiree medical plan sponsors may already have captive insurance companies that provide insurance and reinsurance for other liabilities of the plan sponsor and its affiliates. Although Revenue Ruling 2014-15 assumed that reinsurance of the Policy was the Subsidiary's sole business, the captive insurance company that had requested the private letter ruling that became Revenue Ruling 2014-15 had, in fact, been providing a variety of casualty coverages, as well as insuring a portion of the life, disability, and medical liabilities of the plan sponsor's non-U.S. employee benefit plans. Retiree medical plan sponsors may be interested in expanding the use of their existing captive insurance companies to include an arrangement similar to the one described in Revenue Ruling 2014-15.

Likewise, many retiree medical plan sponsors who are currently self-insuring their plans (rather than directly purchasing an insurance policy to pay claims) already fund such self-insured plans through a VEBA. These retiree medical plan sponsors may be able to structure their plan funding in substantially the same manner as Revenue Ruling 2014-15 by causing the VEBA to purchase a policy that is reinsured through the plan sponsor's captive insurance company. However, Revenue Ruling 2014-15 specifically states that it does not address issues that may arise if an employer provides welfare benefits other than through a VEBA. Similarly, although the plan sponsor's and VEBA's ability to cancel retiree medical coverage at the time that the Policy became effective was critical to the Service's analysis, most retiree medical plan sponsors have the ability to cancel retiree medical coverage at any time.

Retiree medical plan sponsors and their captive insurance companies may generally rely upon Revenue Ruling 2014-15 without the need to request their own private letter rulings on the same issues, provided that their facts and circumstances are substantially the same as those of Revenue Ruling 2014-15 and that Revenue Ruling 2014-15 remains determinative when considering subsequent legislation, regulations, cases, and other revenue rulings.[7]

Although retiree medical plan sponsors and their captive insurance companies may not need to request their own private letter rulings, Revenue Ruling 2014-15 briefly mentions a Department of Labor ("DOL") exemption from certain prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"). In fact, reinsurance of the Policy by the Subsidiary may result in an indirect transfer of the Policy premium payments, which are "plan assets," to the Subsidiary, which would be a party-in-interest to the retiree medical plan under ERISA section 3(14)(G). Thus, the retiree medical plan's fiduciaries could be found to have knowingly caused the plan to

[7] *See* Treas. Reg. § 601.601(d)(2)(v)(e).

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engage in a transaction that indirectly transfers plan assets to a party-in-interest. *See* ERISA § 406(a)(1)(D). Likewise, the retiree medical plan's fiduciaries could be found to have used plan assets in their own interest or to have received consideration for their own accounts from the Subsidiary in connection with the arrangement. *See* ERISA § 406(b)(1), (3). Accordingly, it is generally recommended that retiree medical plan sponsors and their captive insurance companies request and receive a prohibited transaction exemption from the DOL to use an arrangement similar to the one described in Revenue Ruling 2014-15.

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