On May 18, 2014, the Internal Revenue Service (IRS) ruled that an employer’s wholly owned captive insurance subsidiary could reinsure the employer’s retiree medical benefit risks and still qualify as insurance for federal tax purposes, even though the retiree medical reinsurance policy was the only business of the captive. The IRS held that the insured risks were those of the retirees and their dependents, not of the employer or the employer’s voluntary employee benefit association that
purchased the insurance policy reinsured through the captive. The ruling will serve as guidance for employers seeking to structure and implement similar captive reinsurance arrangements that are eligible for favorable federal tax treatment.

The Internal Revenue Service (IRS) issued an advance copy of Revenue Ruling 2014-15 (Revenue Ruling) on May 8, 2014. The ruling reached two conclusions:

- A captive reinsurer of retiree medical benefits funded through a voluntary employees’ beneficiary association (VEBA) qualifies as an insurance company under Subchapter L of the Internal Revenue Code of 1986, as amended (the Code)

- The captive reinsurance arrangement between the fronting insurance carrier and the captive reinsurer qualifies as insurance for federal tax purposes because the underlying risks being shifted to the captive reinsurer are risks of the retirees and their dependents, and were distributed among a large group of covered individuals

The ruling will serve as guidance for employers seeking to structure and implement similar captive reinsurance arrangements that are eligible for favorable federal tax treatment.

Captive Reinsurance Arrangements Relating to Employee Benefit Risks

Although employers may self-insure certain employee benefit risks such as retiree medical benefits, employers may also fully insure such risks through the purchase of commercial insurance (meaning the employer pays premiums to an insurer in exchange for the insurer accepting the risk of paying all of the incurred retiree medical claims). Amounts paid by an employer for commercial insurance are generally deductible under Section 162 of the Code. An employer also may choose to provide health benefits for employees and retirees by making contributions on their behalf to a VEBA; these contributions generally would be deductible under Section 419 of the Code. The VEBA then pays the claims, or purchases insurance to pay the claims, out of the assets of the VEBA trust.

A captive insurance arrangement can also be used in connection with employee benefit risks. One approach is for an employer, either on its own or through a VEBA, to purchase an insurance policy from an unrelated commercial insurance company (a fronting carrier) to insure its employee or retiree benefit risks. The fronting carrier can then cede up to 100 percent of the insured risks to a wholly owned subsidiary of the employer (the captive reinsurer). The captive reinsurance arrangement may provide a number of potential advantages for the employer over traditional insurance, including possible savings on insurance premiums for the employer and better alignment of employee benefit risks with the employer’s overall risk management strategy.

Revenue Ruling 2014-15

In order to determine the federal tax treatment of a captive reinsurance
arrangement, the IRS considers the relevant facts and circumstances, including whether there is sufficient shifting and distribution of the risks involved.

In the Revenue Ruling, an employer’s VEBA purchased retiree health insurance from a state-licensed accident and health insurance company (fronting carrier). The fronting carrier/insurance company contracted to provide reimbursements to the VEBA for medical claims incurred by covered retirees and their dependents and paid by the VEBA. In order to keep the premium payment under the fronting carrier’s insurance contract affordable, the fronting carrier/insurance company entered into another insurance contract with the employer’s wholly owned subsidiary, under which the wholly owned subsidiary received a premium and reinsured 100 percent of the fronting carrier/insurance company’s liabilities under the employer’s retiree health insurance coverage.

The IRS found that the risks being indemnified were the covered retirees’ and their dependents’ risks of incurring medical expenses during retirement due to accident and health contingencies. Although the VEBA purchased the insurance contract from the fronting carrier, the IRS found that the risk of economic loss being transferred to the insurer was not the VEBA’s risk but the retirees’ risk. The covered retirees’ health insurance is an economic benefit to the retirees, not the employer, because it relieves the retirees of the expense of purchasing health insurance for themselves and their dependents. The risks were not those of the employer or the VEBA because neither was obligated to provide the benefits and either could cancel the benefits at any time. Rather, the IRS found that the risks being reinsured were the risks of the retirees and their dependents, and were distributed among this large group of covered individuals. Consequently, there was sufficient risk distribution in this group for the IRS to determine that the reinsurance contract constituted insurance for federal tax purposes.

In determining whether the captive reinsurer qualified as an insurance company, the IRS pointed out that Section 831(a) of the Code defines an insurance company as any company with more than half of its business during the taxable year involving the issuance of insurance or annuity contracts or the reinsurance of risks underwritten by insurance companies. In the Revenue Ruling, the IRS found that the captive reinsurer qualified as an insurance company for federal tax purposes because it was an insurance company regulated under applicable state law and more than half of its business during the taxable year involved the reinsurance of employee benefit risks (in fact, the reinsurance of the retiree medical benefits under the arrangement at issue was the sole business of the captive reinsurer). As an insurance company, the captive’s establishment of loss reserves for anticipated claim payments would be tax-deductible.

Note that employers who want to implement captive reinsurance arrangements with respect to employee benefit risks typically must apply to the U.S. Department of Labor (DOL) for an exemption from the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA) and the Code. The involvement of the fronting carrier is one of several conditions required by the DOL for the exemption to be granted.

**Impact on Employers**
The ruling is significant for employers considering a captive reinsurance arrangement to manage risk with respect to employee benefits because the ruling provides the IRS’ first published support in more than two decades for the position first stated in Revenue Ruling 92-93 that an employer that insures (or reinsures) its employee benefit risks is not self-insuring the risks because the economic risk of loss being insured is that of the employees, not the employer’s. The Revenue Ruling also demonstrates that this same position applies to retiree benefits as well as active employee benefits. Moreover, it applies the principles set forth in Revenue Ruling 2006-26 that even if the employee/retiree benefit risks constitute the captive’s only business, the risks are still sufficiently distributed to constitute insurance for federal tax purposes. This is important to employers because amounts paid pursuant to the arrangement are therefore deductible as insurance premiums under the Code, and the captive is eligible to deduct its loss reserves when computing its taxable income.

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