



**Commercial Insurance and  
Captive Insurance Industry:  
Commonly Accepted Practices**

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## Commercial Insurance and Captive Insurance Industry: Commonly Accepted Practices

The Captive Insurance Companies Association (CICA) is the world's leading captive insurance association. CICA brings together the best of the captive industry to provide the foremost education, networking, and leadership for captive and risk retention group professionals. CICA works with domiciles, captive owners, captive managers, service providers, and regulators, who all come together under the CICA umbrella to represent the interests of the captive industry and speak with a common voice.

The U.S. Tax Court's opinion in *Reserve Mechanical*<sup>1</sup> raises many questions for our membership about insurance transactions and how are they commonly structured. We prepared this document to explain many of those commonly accepted practices. While the issues raised in the *Reserve Mechanical* case are in the context of a small captive insurance company, we believe that the commonly accepted insurance practices shared in this document apply equally to large captives and are often the same practices that are followed by the commercial insurance industry outside of captives.

### 1. Are insurance risk pools common?

Risk pools are mechanisms whereby risks associated with individual insureds are pooled and blended with the risks of multiple insureds resulting in a spreading and distribution of risk among the group. The insureds in such a pool may be related or unrelated. A quota share risk pool (or any arrangement that is similarly structured) is common in the traditional insurance industry and in the captive insurance industry.<sup>2</sup>

The "quota share" or "proportional" type of risk pooling arrangement is commonly used with captives because the parent corporations often are not large enough to have sufficient spread of risk on their own through entities or risk units to achieve a desired level of risk diversification. The IRS has issued Private Letter Rulings recognizing quota share risk pools as insurance for small captives<sup>3</sup> and for large captives.<sup>4</sup>

In a quota share arrangement, various insureds transfer risk and corresponding premium to a risk sharing pool. The pool is then obligated for the insureds' risks. The pool can be structured like a mutual insurance company by holding onto premium to cover losses and expenses of the group, and then sending profits (if any) back to the insureds based on their proportionate share of

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<sup>1</sup> *Reserve Mechanical v. Commissioner*, T.C. Memo. 2018-86.

<sup>2</sup> A quota share arrangement is insurance terminology for a proportional or pro rata arrangement of sharing risks.

<sup>3</sup> PLRs 200950016, 200907006, 201030014, 201219009, 201219010, and 201219011, and 201224018.

<sup>4</sup> CCA 200844011.

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premiums paid to the pool. Or, the pool may reinsure some or all of the risk to reinsurance companies, including captives owned by the insureds in the risk pool.

The following three risk pool structures are very different in the contractual flow of funds and risk, but often produce economically equivalent results. Method A: each insured business insures a portion of its risk with an unrelated pooling entity, which then reinsures a quota share of the risk to each captive. Method B: each insured business insures its risk with a related captive, which then reinsures a portion of its risk with an unrelated pooling entity, which then retrocedes (re-reinsures) a quota share of the risk to each captive. Method C: similar to Method B except that instead of using a pooling entity, the sharing of risk is done by contract – each insured insures with its affiliated captive, and the captives contract with each other to assume a quota share of every other participating captive’s risks.

Each participant in the risk pool bears a percentage of the pool’s risk, typically in proportion of the premium that such participant (or its affiliates) paid into the pool as a percentage of total premium. The participant transfers its own risk to the pool, but it receives and bears financially (directly or through an affiliated captive) a proportional share of the group’s risk. After the insurance policy period is over (typically one year, but can be longer or shorter) the participants will experience an underwriting profit or loss based on the performance of the group, rather than an individual’s insured risk. Almost invariably this produces a different economic result than if one did not participate in the pool. There are many acceptable variations of risk pools.

Example<sup>5</sup>:

*Three independent car fleet operators wish to pool auto physical damage risk among the group and to*

Chart A: Premiums and Risk Transfer

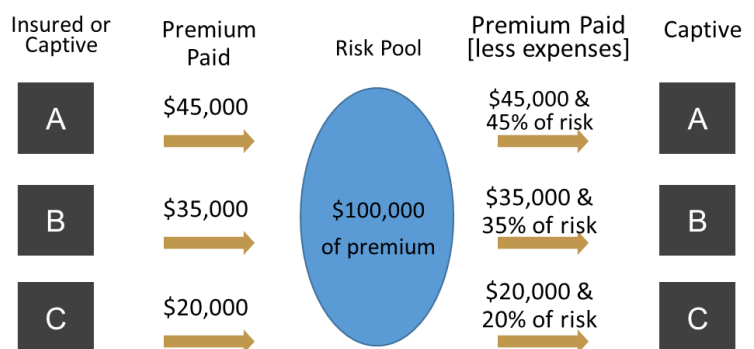
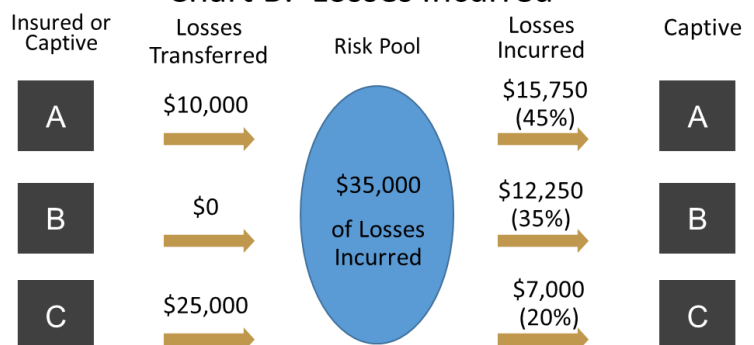


Chart B: Losses Incurred



<sup>5</sup> To make the example simpler, only 3 entities pool their risks and only 100 cars are insured; in practice there would be more entities and more cars insured. The intent of this example is to illustrate the mechanics of pooling and the change in economic position, and not to comment on the minimum number of entities or exposure units required or desirable for a pool. However, this example does illustrate a pool with more than 50% unrelated risk. See, e.g., Rev. Rul. 2002-89, 2002-2 C.B. 984.

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reinsure this risk to their respective captive insurance companies. An actuary priced the risk transfer premium at \$1,000 per car per year. A has 45 cars and pays \$45,000 into the pool. B has 35 cars and pays \$35,000 into the pool. C has 20 cars and pays \$20,000 into the pool.

In Chart A their respective captives receive a quota share of the premium and risk equal to the proportion of premium the affiliated insured paid into the pool (e.g., A paid \$45,000 of \$100,000 total premium and therefore takes a quota share of 45% of the \$100,000 premium into A's captive). In other words, for each \$1 of premium transferred there is \$1 dollar of risk received. However, the risk received is markedly different than the risk transferred. For instance, without pooling, A's captive would have retained 100% of A's risk, but none of B's or C's risks. With pooling, A's captive would assume 45% of A's, B's, and C's risks.

In Chart B assume during the policy year the amount of auto physical damage losses incurred is as follows: A (\$10,000), B (\$0), and C (\$25,000). Because these risks are insured by the risk pool with a corresponding quota share reinsurance arrangement with their respective captives, A's captive pays \$15,750 of losses, B's captive pays \$12,500 of losses, and C's captive pays \$7,000 of losses. This demonstrates the different risks assumed with and without pooling. For instance, B's captive bears \$12,250 of losses, but would have had none if it had not pooled and only insured B. On the other hand, C and C's captive benefitted greatly by pooling. If C's captive had not pooled, it would have borne all \$25,000 of C's losses. Not only did \$25,000 exceed the \$7,000 of losses C's captive paid under pooling, but it also exceeded the \$20,000 C paid in premiums.

This is a simple example with three participants with one type of policy. But pools can have many participants and multiple types of policies.

Quota share risk pools are not unique to captives. The concept of risk pooling is fundamental to mutual insurance companies, group captives<sup>6</sup>, and risk retention groups; more generally it is fundamental to risk distribution and insurance. There are many examples where similar risk pooling arrangements are used outside of captives.

- a) Public entity pools. There are nearly 70,000 public entities in the United States that insure some of their risk exposure through risk sharing pools. This includes municipalities, school districts, cities, fire departments, and police departments.<sup>7</sup>

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<sup>6</sup> Rev. Rul. 78-338, 1978-2 C.B. 107, Rev. Rul. 80-120, 1980-1 C.B. 42, and Rev. Rul. 2002-91, 2002-2 C.B. 992, all ruled that the group captive arrangement was insurance for tax purposes.

<sup>7</sup> "There are more than 90,000 public entities in the United States. The Association of Governmental Risk Pools (AGRIP) estimates that at least 80 percent of all local public entities participate in one or more risk pools. Pooling is prevalent among smaller and mid-sized public entities because they derive especially powerful benefits from sharing risk through a pool."

[http://www.agrip.org/assets/1/6/PR\\_Toolkit\\_Messaging\\_Document.pdf](http://www.agrip.org/assets/1/6/PR_Toolkit_Messaging_Document.pdf) pg. 2. "[T]hey return excess funds to their members through dividends or rate credits." *Id.*, pg. 13.

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- b) Residual market pools.<sup>8</sup> These are for risks that the commercial insurance market will not write, for coverages mandated by state law (e.g., workers compensation and in some states auto liability). These pools are also formed for coverages that are not mandated by law but are generally needed as a safety net to society for high risk areas and often viewed as insurance of last resort (e.g., homeowners, property).
- c) Industry Pools. There are many industry specific pools that are often organized as group captive insurance arrangements. This type of captive insures the risk of a group of unrelated insureds. Examples of these kinds of arrangements are:
  - i. Oil Insurance Limited (OIL) is a risk pool for many of the world's largest oil companies.<sup>9</sup>
  - ii. Nuclear Electric Insurance Limited (NEIL) is a risk pool for many U.S. and international nuclear power plants.<sup>10</sup>
  - iii. Airline risk pool.<sup>11</sup>
  - iv. Shipping risk pool for protection & indemnity clubs.<sup>12</sup>
- d) Economically, mutual insurance companies pool risks with the net profits flowing to the benefit of policyholders, the insureds. An example of this is Associated Electric & Gas Insurance Services Limited (AEGIS).<sup>13</sup>

Risk-sharing pools are common and needed in that they serve a fundamental purpose of insurance: by pooling risk, each participant reduces its exposure to a large loss. In fact, in even a cursory review of the history of insurance, one will quickly see that pooling risks and resources was a key factor in the world's first insurance companies.<sup>14</sup>

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<sup>8</sup> As defined by the International Risk Management Institute, “[r]esidual markets require insurers writing specific coverage lines in a given state to assume the profits or losses accruing from insuring that state's residual risks in proportion to their share of the total voluntary market premiums written in that state.”

<https://www.irmi.com/term/insurance-definitions/residual-market>.

<sup>9</sup> <https://www.oil.bm/about-oil/at-a-glance>. Rev. Rul. 78-338 is said to be based on the facts of OIL at the time.

<sup>10</sup> NEIL has its roots as a mutual insurance company. Surplus from favorable financial results is shared with members through annual declared distributions. <https://myneil.com/media/1154/2016-annual-report-financials.pdf>.

<sup>11</sup> <https://www.global-aero.com/about/history>.

<sup>12</sup> 90% of the world's ocean-going tonnage is insured by thirteen principal underwriting associations (Clubs). These Clubs share risk between themselves through a risk sharing pool. “The Pool provides a mechanism for sharing all claims in excess of US\$ 10 million up to, currently, approximately US\$ 7.75 billion.”

<https://www.igpandi.org/group-agreements>.

<sup>13</sup> “[AEGIS] policyholders represent virtually the entire energy infrastructure in North America.”

[https://www.aegislink.com/about\\_aegis.html](https://www.aegislink.com/about_aegis.html).

<sup>14</sup> In its early days Lloyds of London operated “as a partially-mutualised marketplace within which multiple financial backers, grouped in syndicates, come together to pool and spread risk.”

[https://en.wikipedia.org/wiki/Lloyd%27s\\_of\\_London](https://en.wikipedia.org/wiki/Lloyd%27s_of_London).

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## 2. Is it common for quota share risk pools to have the same amount of dollars going in as are being reinsured out?

Quota share risk pools often reinsure 100% of their risk to captives or other types of reinsurers. In reinsuring or ceding risk, it is very common for risk pools to have gross written premium that is the same on each side of the transaction (often subject to a ceding commission retained by the pooling entity to cover expenses and provide a profit). In other words, the gross written premium paid by the insureds who are buying the pooled lines often matches (at least initially) the gross reinsurance premium receivable by their captives. In fact, unless the pooling entity retains risk, it will almost always cede the same risk, at the same price, to the participants, less a ceding commission or other agreed expense. That said, the net premium paid/booked/owed to the reinsurer captive can be less than the gross depending on whether items like ceding commissions, expenses, claims payments or quota shares of claim reserves are owed or taken out of the reinsurance premium.

A quota share risk pool will often share a layer of risk but not the entire risk; this is very common. Some pools share a primary layer of risk starting from the first dollar of any loss up to a set limit. Other pools share a severity layer of risk, insuring a layer that starts above the captive's layer (or the insured's retention). There can be many appropriate variations in design. The key is that the premium is reasonably priced for each risk layer transferred or received by the various participants (e.g., the insureds, the captives and the pool itself).

An actuary may explain how premiums are calculated in a quota share risk pool in this manner (a Method B premium flow is used in this example):

*Premiums are based on expected losses for each captive and may include amounts attributed to expenses and underwriting risk. Similarly, premiums may be based on other methodologies including factoring expected losses for each line insured and total losses under all lines reinsured. The quota share percentages for the pool are established based on each captive's share of the total expected losses for all captives based on the results of each captive's actuarial analysis.*

An actuary may explain the losses flowing to and from the risk pool as follows (ignoring any ceding commissions):

*Each captive has coverage for its own losses and cedes these losses to the pool for recovery. In turn, the captive assumes back its quota share of the pool's losses. While premiums ceded and assumed are equal, the losses ceded and assumed are not. The losses assumed by the captive are in all likelihood more diversified and less variable than the losses ceded. (The diversification may stem from the larger number of exposures insured or from a broader array of exposures being insured by geography, coverage, industry, insurance classifications,*

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*etc.) More diversified losses should be less variable and therefore more predictable. This is an essential element in risk transfer and is one of the hallmarks of insurance. The business purpose for the captives participating in such a pool—to reduce the risk profile of their retained losses—is met in this way. Plus, structured in this way, the premiums ceded (transferred) to the pool will by definition equal the premiums assumed (received) back from the pool. This equivalence of premiums is not a “circular flow of funds”, but rather a natural consequence of arm’s length transactions; the risks ceded (transferred) for a given premium equal the risks assumed, which must, by definition, be equal to the same premium (subject to any ceding commissions).*

In the risk pool example discussed in Question No. 1, generally each participant’s percentage share of the profits and losses of the pool is based on the proportion of the premium that a participant transferred into the pool, divided by the total premium that all participants transferred into the pool. For example, if Business “A” transfers \$1 of premium to the pool, then Business “A”’s affiliated captive will receive \$1 of premium transferred from the pool and attached to that premium will be a blend of the claims and expenses and potential profit from the group’s performance (i.e., the pool’s performance). In this way all pool participants are treated fairly and equitably based on the relative size of the premium that they are sharing. Unrelated parties would not normally join risk pools if they were required to take on more expected risk than they are sharing with the group. Conversely, it would not be proper for a participant to assume less expected risk than it is sharing with the group.

A quota share risk pool (e.g., for each \$1 of premium transferred in the captive receives \$1 of premium from the pool) is favored by the relevant accounting standards. A key determinant of a contract’s status as an insurance contract is showing that the contract performs risk transfer. The Financial Accounting Standards Board (FASB) and the Statements of Statutory Accounting Practices define risk transfer requirements.<sup>15</sup> Their requirements are similar. In order to be treated as transferring risk and therefore subject to reinsurance accounting, a contract must satisfy one of two conditions: 1. The reinsurer must assume “substantially all” of the underlying insurance risk,<sup>16</sup> or 2. The reinsurer must assume “significant” risk and it is “reasonably possible” that the reinsurer can suffer a “significant loss”.<sup>17</sup>

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<sup>15</sup> Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 944, “Financial Services—Insurance” (FASB ASC 944); and Statements of Statutory Accounting Practices (SSAP) 62R “Property and Casualty Reinsurance” (SSAP 62R).

<sup>16</sup> Accounting Standards Codification (ASC) 944-20-15-53.

<sup>17</sup> ASC 944-20-15-41. “Reasonably possible” is defined by FASB to be “the chance of the future event or events occurring is more than remote but less than likely.” The term “remote” is defined as “the chance of the future event or events occurring is slight.” ASC 450-20-25-2.

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A straight quota share reinsurance arrangement with no risk-limiting features is an example of a contract that is considered reasonably self-evident as satisfying the “substantially all” condition for risk transfer.<sup>18</sup> If that condition is not met, testing could be performed to show satisfaction of the other condition (i.e., satisfying significant insurance risk and reasonably possible standard). If either of these conditions is met, then the contracts (i.e., the reinsurance contracts under review) are considered to have risk transfer. If each insurance contract meets risk transfer, then the risk the pool is (re)insuring will meet risk transfer, and the quota share risk the captive assumes (or reinsures) will also meet risk transfer.<sup>19</sup>

These accounting standards favor pure quota share arrangements because the participants (such as captives) are assuming “substantially all” of the underlying insurance risk. Further, each of the captives assuming risk is essentially “stepping into the shoes” of the quota share risk pool and the pool’s assumption of significant risk and the pool’s reasonable possibility of suffering a significant loss.<sup>20</sup> In other words, with a quota share risk pool, both independent conditions 1 and 2, as described above, are generally met.

Therefore, the legitimacy of quota share risk pools—common in the insurance industry—is also supported by the relevant accounting standards.

### **3. How do commercial insurance carriers draft insurance policies when insuring multiple related entities?**

It is common practice for captives to write (i.e., underwrite, draft, and issue) policies just as commercial insurance companies write policies. When a commercial insurance carrier issues an insurance policy to a group of related entities, it is common that the policy document will:

- a) Have a named insured on the declarations page and may either i) have a list naming all other insured entities, or ii) incorporate them under the policy definition of who is an insured.

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<sup>18</sup> “In summary, straight quota-share contracts are typically exempt from risk transfer requirements...” Reinsurance Attestation Supplement 20-1, Risk Transfer Testing Practice Note, American Academy of Actuaries, pg. 14 (January 2007).

<sup>19</sup> It also follows that if one or more of the contracts do not meet risk transfer, that contract is not accounted for as insurance to the risk pool or the captive, but rather deposit accounting. <https://www.irmi.com/term/insurance-definitions/deposit-accounting>. In this situation the remaining insurance contracts would continue to follow insurance accounting.

<sup>20</sup> IRS rules provide a “step into the shoes” treatment for a captive reinsurer to look through the intermediary insurance company (e.g., risk pool) to the underlying risk being insured. Rev. Rul. 2009-26, 2009-38 I.R.B. 366.

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- b) Identify as insureds all related entities having common ownership regardless of whether some of the entities only need part, but not all, of the coverages listed. These insureds are often identified as a class, but may instead be individually named.<sup>21</sup>
- c) Specify one premium price for each line of coverage, or one price for multiple coverages. Premium is typically not allocated to each insured entity. If any detailed premium is split out, it is typically by location or exposure.
- d) Contain an “other insurance clause,” which is a provision that establishes how a loss is apportioned between multiple insurers when more than one policy covers the same loss.<sup>22</sup> This prevents policies from two different commercial insurance companies (or a captive and a commercial insurer) from duplicating coverage. This language could specify that such policy applies excess of any other insurance policy or applies on a pro-rata basis.

What is basic and typical in commercial insurance should be acceptable in captive insurance arrangements.

#### **4. Is it common for a company to maintain its commercial insurance coverage when a captive insurance program is begun?**

It is common that no changes occur in an insured’s commercial insurance program when a captive is introduced. A business will purchase the amount of insurance from the commercial market it determines is appropriate. Sometimes a business purchases less insurance from the commercial market than desired because the additional coverage is unavailable, too expensive, too volatile, too restrictive, etc. Whatever risk is retained could be either self-insured or financed through a captive insurance company.

Over time changes may be made to the commercial insurance program based on market forces, the insured’s risk tolerance, and the captive’s performance. For example, in the U.S. Tax Court case *Rent-A-Center*, no changes were made to the commercial insurance policies when the captive started. The captive took on insuring only Rent-A-Center’s previously self-insured risk. The dissenting opinion in *Rent-A-Center* complained, “the entire arrangement was orchestrated exactly as it had been orchestrated before 2003, when the Rent-A-Center group maintained a self-insurance reserve for the tranche of risks purportedly ‘insured’ by Legacy.”<sup>23</sup> Yet the dissenting opinion in that case failed to understand that when the captive is utilized to insure previously self-insured risks of the business, it is very common for the captive to not replace the commercial lines of insurance or change the commercial program. That is, captives often function as “risk financing vehicles” for previously self-insured risks.

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<sup>21</sup> This means, for example, that a commercial insurance policy may provide coverage for certain insureds in a related group that do not have any risks for that particular policy. This is normal and customary.

<sup>22</sup> See, <https://www.irmi.com/term/insurance-definitions/other-insurance-clause>.

<sup>23</sup> *Rent-A-Center*, 142 T.C. 1, 45. (2014).

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An example can illustrate: Suppose a business in South Florida pays \$200,000 for commercial insurance, none of which covers wind, windblown rain, or flood from named storms (e.g. hurricane). If the business then decides to purchase such coverage from Travelers on a \$10,000,000 facility with a 5% rate on line, the premium would be \$500,000. Everyone would agree that this named storm coverage is insurance, notwithstanding that the original commercial insurance policies stayed in force. The same would be true if the policy was purchased from a captive rather than Travelers.

#### **5. Is it common for operational duties of a captive to be delegated to outside parties?**

In our modern economy many things are outsourced. It is common in business for the owner to delegate some or all of the management of a particular function to a third party, allowing the owner to focus on the primary operations of the business. For example, it would be unusual to criticize a business owner for outsourcing the key functions (operation, education, compliance) of the company's 401(k) plan. This reality is true for many areas in business, including the management of captive insurance companies. Nearly all captives are managed by third-party "captive management firms," including most captives of *Fortune 500* companies. This also fits the fact pattern of *Rent-A-Center*, where no employees were maintained by the captive, and Rent-A-Center hired a third-party as a captive manager.<sup>24</sup>

#### **6. Is a prior loss in a particular area, or eliminating other insurance policies, required before buying insurance?**

There is no requirement in commercial insurance that prior losses occur before a business may buy that particular line of insurance. Nor is there a prohibition on a business buying more insurance in future years on risks that it chose not to insure in the past or new risks that evolve. Many businesses buy insurance on risks where they never had a loss in the past and for which they may be purchasing coverage for the first time, such as cyber liability, directors & officers, earthquake, flood, and business interruption. This is actually a fundamental tenet of good risk management, to identify risk before a loss event happens and to do something proactively and not reactively—such as setting up better loss prevention or safety measures or buying insurance. Examples of individual insurance buyers purchasing insurance on things where a loss has never occurred before include homeowners' and car insurance.

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<sup>24</sup> "For ease of operations, including running payroll, companies create a staff leasing subsidiary and lease employees companywide. Or they hire outside consultants to handle the operations of a specialty business such as a captive insurer." *Rent-A-Center* at 30. "[The captive] had no employees and no separate offices in Bermuda and operated in Bermuda through a management company specializing in managing captive insurance companies." *Kidde Industries, Inc. v United States*, 40 Fed. Cl. 42, 52 (1977). "In implementing the arrangement, [the captive] may perform all necessary administrative tasks, or it may outsource those tasks at prevailing commercial market rates." Rev. Rul. 2002-89, 2002-2 C.B. 984.

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Another example: the federal government mandates that all insurance companies, including captives, must offer a government-backed terrorism insurance endorsement on certain insurance lines regardless of how low a terrorism risk may be for a particular insured. Since inception in 2002, over \$24 billion in terrorism risk insurance premiums were earned and *yet there has not been a single loss that met the criteria to trigger the government backstop to pay a claim.*<sup>25</sup> Would we thus consider this *not* to be insurance? No. While it is true that some in the United States have experienced a devastating terrorism loss, there is no restriction to the Federal government's program that entrants must show prior terrorism loss or high terrorism risk as a requirement for buying government backed terrorism insurance.

#### **7. Is vehicle service contract risk a legitimate risk that insurance companies insure?**

Vehicle service contract (VSC) risk is insured by thousands of reinsurance companies, many of which make the tax code 831(b) tax election.<sup>26</sup> These are primarily owned by auto dealerships offering such contracts to car buyers. The IRS scrutinized this practice heavily from 2002 to 2004, concluding that these companies had "fewer abusive transactions than anticipated" and therefore would no longer be subject to listed transaction status.<sup>27</sup>

VSCs are risks that can be insured and reinsured by captive insurance companies. Such risks can be pooled by participants if desired.

#### **8. Is the use of standardized language in insurance policies common?**

It is standard practice that the insurance policy language in commercial insurance and captive insurance transactions is drafted with the same or with similar language from client to client. Many insurers license copyrighted insurance policy language from Insurance Services Office (ISO), an organization that provides policy writing and other services to commercial and captive insurers.<sup>28</sup>

Standardized insurance policy language is customary, as insurers (including captives) want the confidence of using language and clauses that are tried and true, such as with commonly understood interpretations of coverage language. Such interpretations have evolved through

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<sup>25</sup> *Report on the Effectiveness of the Terrorism Risk Insurance Program*, by Federal Insurance Office, Department of Treasury, June 2018, pg. 71 and footnote 158.

<sup>26</sup> "[Turks and Caicos] has over 2,400 companies licensed as niche hybrid reinsurance companies." <https://www.captive.com/Resources/captive-domicile-showcase/turks>.

<sup>27</sup> Notice 2004-65, 2004-2 C.B. 599, removed Producer Owned Reinsurance Companies from Listed Transaction status. Another example where the IRS and the industry originally disagreed on the federal tax treatment of a risk is the case of residual value insurance. See IRS's earlier position on residual value insurance in TAM 201149021 (Dec. 9, 2011). This position was overturned by the tax court in *R.V.I. Guaranty Co. Ltd. V. Commissioner*, 145 T.C. No. 9 (Sept. 21, 2015).

<sup>28</sup> <https://www.verisk.com/insurance/brands/iso>.

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professional claims practices as well as through statutory and common law. Standard language is particularly helpful in pooling arrangements, where all participants share in the pooled risks and interpretation of claims coverage can be more uniform. Captives may also write unique, customized policies for their insureds, sometimes referred to as “manuscript” policies or endorsements.

**9. In determining a reasonable amount of premium for a particular insurance policy, is it common to have the premium amount set by an actuary, use an arm’s length standard, or some other method?**

In the captive industry, it is common to have an actuary involved in the premium pricing. It is also common for captives to charge market-based premiums (i.e., arm’s length). However, there are other ways to arrive at a reasonable premium that do not involve actuarial analysis or market rate comparisons. Instead, the premium may be derived based on an estimate of future loss exposure based on an underwriter’s work or some other insurance professional.

For example, the taxpayer in *Rent-A-Center* used an actuary to determine the overall premium paid to the captive, but did not use an actuary in determining the amount of premium charged to each subsidiary. As stated in the *Rent-A-Center* opinion, “[t]here was no actuarial determination of the premium payable to Legacy [the captive] by each operating subsidiary based on the specific subsidiary’s risk profile.”<sup>29</sup> Further, this opinion explained, “[i]n a captive arrangement, a parent may allocate a premium among its subsidiaries.”<sup>30</sup> And to support its point this opinion referenced a prior court case example, “National determined the premiums that it charged Kidde based in part on underwriting data supplied by Kidde’s divisions and subsidiaries....”<sup>31</sup>

This approach taken by Rent-A-Center was upheld by the Tax Court.

Even commercial insurance companies do not base their premiums merely on estimated losses. Sometimes commercial insurance companies offer insurance at a rate below expected loss payments in an effort to gain market share. Other times they charge significantly above the estimated loss payments. Reasons for charging high premium rates include: market forces allow them to make that profit, risk of loss is highly speculative and commands higher returns, risk of loss requires significant capital costs that need to be considered, and they are trying to recoup payouts from prior year catastrophic losses.

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<sup>29</sup> *Rent-A-Center* at 45.

<sup>30</sup> *Rent-A-Center* at 27.

<sup>31</sup> *Rent-A-Center* at 27, quoting *Kidde Indus., Inc. v. United States*, 40 Fed. Cl. 42, 45 (1997).

***This discussion of commonly accepted practices has been prepared by the Captive Insurance Companies Association (CICA) and is intended to provide guidance to the captive insurance industry. It is NOT tax advice. You should seek advice from your professional advisors on any accounting or tax matters.***