
The

Risk Retention Reporter

Yet Another Twenty Things You'd Always Wanted to Know About Reciprocal (But May Not Have Thought to Ask)

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This article reviews important accounting and federal tax issues for reciprocal insurance companies, including reciprocals that qualify as risk retention groups. It continues the discussion of structural and operational issues regarding reciprocal RRGs begun in July 2003 in the *Risk Retention Reporter* article — *Twenty Things You'd Always Wanted to Know About Reciprocals (But May Not Have Thought to Ask)*.

Applicable Laws

1. What laws apply to the formation and operation of a reciprocal RRG?

A reciprocal RRG is organized and licensed to transact the business of insurance under a state's insurance code. If the reciprocal is also a captive insurance company, the state's insurance statutes regarding captive insurers and reciprocal insurers will apply to the formation and operation of the reciprocal. The federal Liability Risk Retention Act (LRRRA) preempts the application of most state insurance laws (other than those of the domicile state) to reciprocal RRGs, but only if the reciprocal meets the definition of a "risk retention group" under the LRRRA. (Note that if an RRG uses an agent or broker to place its coverage, the producer is subject to state insurance producer licensing laws.) Finally, the federal Internal Revenue Code of 1986 (the "Code") and the Treasury Regulations determine the calculation of the reciprocal's annual federal taxable income and income tax liability.

In general, state reciprocal insurer laws fall into two categories: New York and everywhere else. Since the formation of the first reciprocal insurer in 1881 (formed by six New York City dry goods merchants to share fire risks), New York has had its own reciprocal law. Most of the rest of the states that have reciprocal laws originally adopted a uniform law drafted in 1912 by the National Convention of Insurance Commissioners (the

predecessor to the National Association of Insurance Commissioners), but since that time various amendments in those states mean that their reciprocal laws are not necessarily identical. Any group forming a reciprocal RRG should carefully review the reciprocal laws of its chosen state of domicile.

2. What else governs a reciprocal's operations?

The Subscriber's Agreement and Power of Attorney ("Subscriber's Agreement") is the primary document governing the organization and operation of the reciprocal RRG. The Subscriber's Agreement generally includes provisions regarding: (i) conditions for becoming a subscriber, including the amount of any required or discretionary capital contributions; (ii) rights to distributions; and (iii) termination of a subscriber's participation in the reciprocal insurance program. The reciprocal will also be subject to governance rules, which are analogous to corporate bylaws.

3. Is a Reciprocal a Mutual Insurance Company?

In some respects, yes. A mutual insurance company is a corporation without shares of stock or shareholders. It obtains working capital from premiums paid by policyholders, and the policyholders are the only persons entitled to share in the mutual's profits, i.e., the policyholders are the equity owners. Similarly, a reciprocal obtains working capital from its subscriber-policyholders, who share in the reciprocal's profits as equity owners. But unlike a mutual, which is a corporate entity, a reciprocal is an unincorporated association. A reciprocal exists only by reason of the fact that each subscriber has appointed the attorney-in-fact, which acts on the subscriber's behalf to pay its share of an insured loss that another subscriber suffers. From a legal and operational perspective, the attorney-in-fact is the linchpin of the reciprocal insurer.

Contributed Capital Accounting for Net Equity/ Distributions

4. How does a reciprocal obtain operating capital?

In general, a reciprocal obtains operating capital from its subscribers. The contributed capital (a.k.a. “contributed surplus”) is generally a one-time cash contribution by the subscriber to the reciprocal. Subscribers may be subject to assessment for additional cash contributions if the reciprocal issues assessable insurance policies. A reciprocal can accept operating capital from other sources, including the attorney-in-fact, subject to state regulatory approval. Anyone organizing a reciprocal should review the report of the Government Accountability Office report — *Risk Retention Groups: Common Regulatory Standards and Greater Member Protections Are Needed*, GAO-05-536 (Aug. 2005) — regarding RRGs and the Risk Retention Act, which expressed concern about RRGs that require little to no capital contributions from members and that obtain significant capital from third parties.

5. How does a reciprocal determine the amount of a subscriber’s surplus contribution?

The insurance regulators of the reciprocal RRG’s domicile state will impose minimum capital and surplus requirements for the RRG’s operations as part of the licensing process. State insurance laws and the LRRRA do not, however, include any requirements, guidelines or prohibitions as to how a reciprocal determines an individual subscriber’s initial surplus contribution. Generally the Subscriber’s Agreement authorizes the Subscriber Advisory Committee (the “SAC,” the reciprocal’s governing board) to determine the amount of initial capital contributions, in its discretion. Often a subscriber’s capital contribution is determined as a percentage of the first-year premium payable by the subscriber for insurance from the reciprocal.

6. How does a reciprocal account for contributed surplus and retained earnings?

Like other insurance companies, the equity section of the reciprocal RRG’s balance sheet contains separate entries for total contributed surplus and accumulated retained earnings (positive or negative, as the case may be). If, as discussed below, a reciprocal makes deductible allocations of net income to subscriber savings accounts, the reciprocal’s balance sheet will divide the reciprocal’s accumulated retained earnings between a “Subscriber Savings” account (which represents the total of all subscriber savings account balances) and “Other Retained Earnings.” Thus, the sum of a reciprocal’s Subscriber Savings account and Other Retained Earnings account will represent the accumulated income and loss from the reciprocal’s operations, less any cash distributed to the subscribers.

7. What rights do subscribers have to the reciprocal RRG’s assets?

An individual subscriber has no ownership rights to any specific asset in the reciprocal. Usually, the subscriber interest (as defined in the Subscribers Agreement) entitles the subscriber to: (i) a vote in matters put to the subscribers; (ii) distributions approved by the SAC and the insurance regulators from time to time; (iii) a distribution if the subscriber terminates its participation in the reciprocal; and (iv) a share of the net assets of the reciprocal upon liquidation. The reciprocal retains control over all surplus contributions and accumulated earnings, including any unassigned surplus and any amounts allocated to the subscriber savings accounts.

8. How does a reciprocal RRG account for annual statutory income and loss?

A reciprocal RRG files an annual statement in the form of the NAIC blank, which includes an income statement and balance sheet computed using the method of accounting approved by the reciprocal’s domicile state insurance regulators. The annual report includes a calculation of the reciprocal’s net income or loss, as applicable. As discussed below, for federal income tax purposes a reciprocal can deduct the amount of statutory net income allocated to subscriber savings accounts. The amount of annual net income or loss not allocated to the subscriber savings accounts is credited to the reciprocal’s Other Retained Earnings account.

9. Is a reciprocal required to allocate income or loss to subscriber savings accounts?

No. A reciprocal is not required by state law or the Code to make any allocation of annual net income or loss to subscriber savings accounts. Absent a provision in the Subscriber’s Agreement or Governance Rules requiring allocations to subscriber savings accounts, the reciprocal’s SAC has the discretion to determine whether and in what amount to allocate annual income and loss to the subscriber savings accounts. The SAC of a reciprocal usually adopts a surplus allocation methodology that includes guidelines for allocations to subscriber savings accounts.

Tax Issues

10. Can a reciprocal RRG take a position as an insurance company for federal income tax purposes?

Yes. But as with any other captive or insurance company, being licensed as an insurance company under state law is not, in itself, sufficient to take a tax position as an insurance company. The two most important factors for qualification as an insurance company for federal income tax purposes are: (i) risk shifting (each insured must be shifting its risk of loss to the insurer for payment of a premium); and (ii) risk distribution (there must be sufficient distribution of independent risks within the insurance company).

11. Are there advantages to being an insurance company for federal tax purposes?

Insurance companies compute their taxable income according to the special tax accounting rules found in subchapter L of the Internal Revenue Code of 1986. These rules include provisions regarding accounting for unearned premium, computation of underwriting losses and gains, and deductions for certain discounted loss reserves, including reserves for incurred but not reported losses. The key advantage that insurance companies have as compared to other business entities is that the insurance company can take a deduction for loss reserves in the year those reserves are established, i.e., an insurance company takes a current deduction for a future payment.

12. Do reciprocals have any special tax advantages over other insurance companies?

Reciprocals have a unique tax advantage over other insurance companies. Code Section 832(f) allows a reciprocal to take a deduction in computing taxable income, equal to the amount of its annual statutory net income that is allocated to the subscriber savings accounts. With the significant caveats noted below, the deduction for subscriber savings account allocations allows the reciprocal to zero out its taxable income annually, and effectively eliminate income tax at the insurance company level.

13. How does the reciprocal determine its income for purposes of the Section 832(f) deduction?

The deduction for allocations of income to subscriber savings accounts is based on the reciprocal's "statutory net income" as reported on its annual statement (i.e., the NAIC blank). If a reciprocal is approved to use GAAP accounting by the insurance regulator for purposes of its annual report, then the net income determined under GAAP is the reciprocal's "statutory net income" for purposes of calculating the deductible allocations to the subscriber savings accounts.

14. Is a reciprocal's statutory net income the same as its taxable income determined without the Section 832(f) deduction?

In most respects yes, but there can be significant differences between the two. The most significant sources of disparity between taxable income and statutory income are unearned premium, capital losses, and differences between the discount factor (if any) used to value loss reserves for book purposes versus the mandatory discount in loss reserves for tax purposes. Another significant book-tax difference will result if the reciprocal RRG writes off all or a portion of an investment determined to be "other than temporarily impaired." In general, for federal tax purposes an investment loss can be deducted only if the investment is actually sold, or if the investment qualifies as a "worthless security" under Code Section 165(g). As a

result, a writedown of an investment on the reciprocal RRG's annual statement does not reduce the company's taxable income.

15. Does the Section 832(f) deduction depend on whether the reciprocal actually distributes allocated amounts to the subscriber?

No. The reciprocal RRG can deduct the allocations of statutory net income to the subscriber savings accounts under Section 832(f) regardless of whether the reciprocal distributes the amounts allocated to the subscriber. See below, however, regarding the payment of the subscriber savings account balance to a subscriber that ends its participation in the reciprocal's insurance program.

16. How do subscribers account for the annual allocations of net income to the subscriber savings accounts?

Subscribers are required to take the annual subscriber savings account allocations into account for purposes of computing their federal income tax liability (similar to a partner in a partnership). Section 832(f) provides that the allocation is treated by the subscriber as a dividend paid or declared by a corporation. If the subscriber is a 501(c)(3) exempt organization, under Code Section 512(b)(1) the dividend is not treated as unrelated business income, so the exempt organization subscriber is not taxable on the subscriber savings account allocation. As a result, there may be no federal income taxes at all on the insurance operations of reciprocal that insures only tax-exempt entities.

17. How do allocations of a statutory net loss affect the reciprocal RRG's federal tax liability?

If a reciprocal RRG has a net loss in a given year, for federal tax purposes the reciprocal will have a net operating loss that can be carried back and forward to other tax years to absorb taxable income. The reciprocal RRG has an alternative to taking the loss in this manner, however. Under Section 832(f), if the reciprocal allocates some or all of the net statutory loss to the subscriber savings accounts (thereby reducing the balances in those accounts), the reciprocal treats the amount of loss allocated as an additional item of income for tax purposes. This effectively reduces or eliminates the reciprocal's net loss for federal tax purposes.

18. How does a subscriber account for its share of an allocated loss?

If a reciprocal RRG allocates part of a statutory net loss to the subscriber savings accounts, in general the subscriber can deduct its share of the allocated loss for federal income tax purposes.

19. What is the federal tax treatment of annual net statutory income that is not allocated to SSAs?

If the reciprocal RRG does not allocate all of a year's net statutory income to the subscriber savings accounts, the reciprocal RRG will be subject to tax on the unallocated income.

20. Does the Code impose any conditions on the Section 832(f) deduction for allocations of income to subscriber savings accounts?

Yes. To deduct statutory net income allocated to subscriber savings accounts, the reciprocal RRG must be “obligated” to pay the amount of income allocated to such account “promptly to such subscriber if he terminated his contract at the close of the company’s taxable year.” Treasury Regulation Section 1.823-6 offers some guidance on this requirement, including the statement that “the requisite legal obligation will not be considered absent merely because a subscriber’s credits remain subject to absorption by future losses if left on deposit with the company.”

Further guidance on the “prompt return” issue is available in two private letter rulings issued in 2007 and

2008: Priv. Ltr. Rul. 200701026 and Priv. Ltr. Rul. 200852018. Any group forming a reciprocal RRG should carefully review the reciprocal laws of its chosen state of domicile.

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