
The

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

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In recent years, interest in reciprocal insurance exchanges has grown as more nonprofit groups have opted for captive insurance as the best means to insure their members without creating taxable income. This article explores the salient aspects of the structure and operation of reciprocals.

Overview of Reciprocal

1. What is a reciprocal?

Reciprocals have been around for many years as a risk-pooling alternative to stock or mutual insurance companies. Participants in a reciprocal are known as "subscribers," which agree to exchange contracts of insurance among themselves and thereby achieve the desired risk pooling. The exchange of contracts is done through an "attorney-in-fact" appointed by all of the subscribers. In general, the attorney-in-fact manages the reciprocal's finances and handles underwriting, claims administration and investments.

2. Is a reciprocal a legal entity?

Yes, but it is not a corporation, partnership or limited liability company. A reciprocal is an unincorporated association formed under a state's insurance code, which has an identity apart from the subscribers and attorney-in-fact. Some state laws, such as Vermont, explicitly provide that the reciprocal may sue and be sued in its own name. In every captive domicile, the certificate of authority to transact insurance is issued in the name of the reciprocal.

3. Do the major U.S. captive domiciles allow captives to form as reciprocals?

Most do. The captive laws of Vermont, Hawaii, South Carolina, and Montana all provide for formation of a group captive as a reciprocal.

4. Can a reciprocal qualify as a risk retention group?

Yes. In general, a reciprocal can meet the requirements of the federal Liability Risk Retention Act of 1986 to qualify as a risk retention group. An RRG must be

formed as a corporation or "limited liability association." For a reciprocal to qualify as a limited liability association, a subscriber's liability for the debts and obligations of the reciprocal is usually limited, generally to the amount of the subscriber's surplus contribution and some multiple of the premium the subscriber pays to the reciprocal for insurance.

Reciprocal Structure and Operations

5. What are the reciprocal's governing documents?

Each subscriber to a reciprocal executes a power of attorney authorizing the attorney-in-fact to act on its behalf, and an agreement with the other subscribers regarding the powers of the attorney in fact, rights to participate in the reciprocal, governance of the reciprocal and rights to the reciprocal's funds. Often these provisions are combined in to a single subscribers agreement/power of attorney. The subscribers also approve governance rules for the reciprocal, which are comparable to corporate bylaws.

6. How is the reciprocal governed?

A reciprocal has a governing board known as the "subscribers advisory committee" (the "SAC"), which has general responsibilities for the finances and insurance activities of the reciprocal, much like the board of directors of a corporation. The subscribers appoint the members of the SAC.

7. What does the attorney-in-fact do?

The subscribers agreement/power of attorney often grants fairly broad powers to the attorney-in-fact to conduct the reciprocal's day-to-day insurance operations. This includes handling funds and financial records and making underwriting and claims decisions. The attorney-in-fact usually has authority to retain third-party service providers to assist with these functions.

8. How is the attorney-in-fact compensated?

The attorney-in-fact may be compensated in addition to reimbursement of expenses, with the terms usually set

forth in the subscribers agreement/power of attorney or determined by periodic negotiations with the SAC.

As part of the licensing process, the captive insurance regulators request detailed information regarding third-party contracts and the attorney-in-fact's compensation, in part to identify any potential risk that the attorney-in-fact's compensation could threaten the solvency of the reciprocal. This is especially true in large multi-state programs such as physician liability programs, in which the attorney-in-fact often exercises considerable control over all aspects of the reciprocal's insurance program and may have disparate bargaining power compared to a person applying for admission to the reciprocal as a subscriber.

9. Must the attorney-in-fact provide security for its obligations to the subscribers?

Yes. This is usually in the form of a bond or other security of \$250,000 or more. Recent legislative changes in Vermont allow the regulators to waive the bond if the attorney-in-fact is affiliated with the subscribers, as might be the case in a group hospital reciprocal program.

10. Do reciprocals issue insurance policies?

This is the standard practice. The reciprocal statutes refer to an "exchange of contracts" among the subscribers, but in general a subscriber is insured in the customary way through an insurance policy issued by the reciprocal to the subscriber in exchange for payment of premium.

11. Are the reciprocal's subscribers subject to assessment of additional premium under their policies?

Subscribers have a "contingent liability" for the debts and liabilities of the reciprocal, usually determined based on premium paid by the subscriber. The reciprocal can request regulatory approval to extinguish this contingent liability, so that the insurance policies are non-assessable. Issuance of non-assessable policies is an important factor to support a reciprocal's position as an insurance company for federal income tax purposes.

Licensing, Surplus and Accounting

12. What are the surplus requirements for reciprocals?

The reciprocal is capitalized through contributions to surplus by the subscribers. (As non-stock entities, for accounting purposes reciprocals do not have capital.) The minimum surplus for reciprocal RRGs is usually \$500,000 to \$1 million, and often higher depending on the reciprocal's insurance program.

13. How does the reciprocal account for the subscribers' surplus?

The reciprocal carries two notional equity accounts on its books for each subscriber. The first is a Paid-in Surplus Account, which is credited with the subscriber's surplus contribution. The second is a Subscriber Savings Account ("SSA"), to which is allocated a portion of the reciprocal's annual operating income or loss.

For accounting, tax and regulatory purposes the SSAs are treated as equity accounts rather than liabilities of the reciprocal to its subscribers. The reciprocal may, however, use funds previously allocated to SSAs to cover its underwriting and investment expenses and losses. The reciprocal may make distributions to the subscribers from time to time, which reduce the balance in the SSAs. In general, the balance of a subscriber's SSA is paid to the subscriber within a reasonable time after the subscriber withdraws from the reciprocal.

Taxation of Reciprocals

14. Are reciprocals subject to state premium taxes?

For state premium tax purposes, reciprocals are treated as any other captive insurance company. The reciprocal is subject to a tax on its insurance and reinsurance premiums written. A reciprocal qualified as an RRG will pay premium tax in its state of domicile and in those states where the reciprocal is registered to write insurance.

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

Yes. But as with any other captive or other 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).

16. If a reciprocal qualifies as an insurance company for federal income tax purposes, what rules apply?

Insurance companies compute their taxable income according to the special tax accounting rules found in subchapter L of the Internal Revenue Code of 1986 (the "Code"). 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.

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

All qualified insurance companies, including reciprocals, are treated as corporations for federal income tax purposes. Ordinarily this means that insurance company income is subject to the "double tax" applicable to most corporations: income is taxed once at the corporate level and taxed again when distributed to the company's shareholders. Insurance companies can deduct amounts paid as policyholder dividends rather than shareholder dividends, and thereby distribute earnings free of the corporate level tax. The insurance company pays a price, however, in that it must actually distribute funds to take the deduction.

Reciprocals have a unique tax advantage over other insurance companies. Code Section 832(f) allows a recip-

reciprocal to take a deduction for the amount of its annual net income that is allocated to the subscriber SSAs. Unlike the deduction for policyholder dividends, the reciprocal is not required to distribute the amounts allocated to the SSAs. With the significant caveats noted below, the deduction for SSA allocations allows the reciprocal to zero out its taxable income annually, and effectively eliminate income tax at the insurance company level.

18. How does the reciprocal determine its income for purposes of the SSA allocation deduction?

The reciprocal's income that can be deducted as SSA allocations is the reciprocal's "statutory income" as reported on the annual NAIC Blank. (Note that if the reciprocal completes the NAIC statement based on GAAP accounting, then GAAP accounting is the basis for the determining the "statutory income.")

The tax accounting rules used to determine the reciprocal's taxable income are not identical to the accounting rules to determine statutory income. The most significant sources of disparity between taxable income and statutory income are unearned premium, capital losses, and differences between the discount factor used to value loss reserves for book purposes (if any) versus the mandatory discount in loss reserves for tax purposes. These disparities have the effect of decreasing statutory income relative to taxable income. Since SSA allocations are based on statutory income, if the book/tax disparities exist the deduction for SSA allocations will not fully offset the reciprocal's taxable income before the SSA allocation deduction, and the reciprocal will have a tax liability.

- **Capital Losses:** For accounting purposes, capital losses are deductible against ordinary income and capital gain; for tax purposes the losses are deductible only against capital gain. Capital losses are usually investment-related, so the limit on deduction of capital losses does not present a significant problem if the reciprocal can realize capital gains. Unfortunately, over the past few years investment losses rather than gains have been the rule.
- **Loss Reserve Discount:** For tax purposes, unpaid loss reserves must be discounted before they are deducted against underwriting income (this is true of all insurance companies, not just reciprocals). Section 846 sets for the method and rate of discount. If these reserves are not discounted for book purposes, or if they are discounted at a substantially lower rate than the discount for tax purposes, this will increase the reciprocal's taxable income.
- **Reduction in Deduction for Unearned Premium:** The computation of a non-life insurance company's taxable income includes the determination of premiums earned on insurance contracts during the taxable year. "Premiums earned" are defined as gross premiums received (less return premium and

premiums paid for reinsurance), plus 80% of unearned premium as of the end of the previous taxable year, and less 80% of unearned premium as of the end of the current taxable year. This 20% discount is the infamous "unearned premium haircut," which requires an insurance company to take premium deemed unearned for book purposes into income for tax purposes.

The unearned premium haircut is an issue for any reciprocal that has an underwriting year different from its taxable year. If, in a subsequent taxable year, the reciprocal changes to an underwriting year that coincides with its taxable year, the change will result in a net operating loss for tax purposes. If the loss can be carried back to the year(s) in which the reciprocal had taxable income, the reciprocal may be entitled to a refund of the tax paid in those previous years.

19. How do subscribers account for the annual allocations to the SSAs?

Subscribers are required to take the annual SSA 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 SSA 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 SSA allocation. As a result, there may be no federal income taxes at all on the insurance operations of a reciprocal insuring only tax-exempt entities.

20. Considering the tax advantages of reciprocals, shouldn't every group captive program be organized as a reciprocal?

Not necessarily. If the potential tax advantages are not a paramount concern, the organizers and participants in a group captive program may find it easier to use a stock or mutual corporation. The laws, rules and procedures for governing the participation of shareholders in a corporation are generally better known to group participants, regulators and insurance service providers than the arcane concepts of the reciprocal, the subscribers and the role of the attorney-in-fact.

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