On May 8, the IRS issued Rev. Rul. 2014-15, 2014-22 I.R.B. 1, which provides guidance in the rapidly expanding area of insuring or reinsuring employee benefits with captives. In the new revenue ruling, the IRS concluded that:

- An arrangement in which certain retiree health benefits offered by an employer through a voluntary employees’ beneficiary association are insured with an unrelated life insurance company and subsequently reinsured with a wholly owned captive insurance subsidiary of the employer-parent corporation constitutes “insurance” for federal income tax purposes; and

- The captive qualifies as an “insurance company” for the taxable year under the definition of that term provided in IRC § 816(a) because more than half of its business during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

In reaching these conclusions, the IRS confirmed the continuing vitality of Rev. Rul. 92-93, 1992-2 C.B. 45, in which it concluded that the parent corporation’s employees should not be viewed as parties that are related to the captive and, correspondingly, that the risks of those employees should be treated as unrelated-party risks for purposes of the insurance analysis.

Sutherland Observation: Rev. Rul. 2014-15 does not speak to, and otherwise does not cover, the use of a captive to insure medical stop-loss coverage for its parent corporation’s self-funded health benefits, although this topic clearly is ripe for guidance. Interest in the use of captives to insure employers’ medical stop-loss coverage has surged following the advent of the Affordable Care Act and its elimination of the lifetime and annual caps that employers historically were allowed to impose on self-funded health benefits.

Background

Rev. Rul. 2014-15 describes a scenario in which a domestic corporation (X) voluntarily provides health benefits to a large group of named retired employees and their dependents. X makes a contribution to its single-employer voluntary employees’ beneficiary association (VEBA) to provide the health benefits. Rather than providing the health benefits to retirees and their dependents on a self-insured basis, the VEBA enters into a contract (Contract A) with an unrelated life insurance company (IC). Under Contract A, which provides noncancellable accident and health coverage, IC will reimburse the VEBA for...
medical claims that are incurred by the covered retirees and their dependents and paid by the VEBA.

In order to keep the premium payment under Contract A affordable, IC enters into a separate contract (Contract B) with X’s wholly owned subsidiary (S1), under which S1 receives a premium and reinsures 100% of IC’s liabilities under Contract A. Contract B is S1’s sole business. IC’s participation in this arrangement is a condition of an exemption from the Department of Labor (DoL) from certain of the prohibited transaction provisions of the Employee Retirement Income Security Act (ERISA).

Sutherland Observation: Rather than garnering the benefit of a class exemption to the prohibited transaction provisions of ERISA, fronting company arrangements such as the one described in Rev. Rul. 2014-15 are subject to review and approval by DoL on a case-by-case basis. One class exemption – Prohibited Transaction Exemption 79-41 (PTE 79-41), 44 Fed. Reg. 46,365 (Aug. 7, 1979) – allows insurance companies that have substantial stock (or partnership) affiliations with employers establishing or maintaining employee benefit plans to sell life insurance, health insurance, or annuity contracts that fund such plans under certain circumstances. However, DoL’s discussion in the preamble to PTE 79-41 makes it clear that an arrangement whereby an unrelated fronting company issues an insurance contract to a plan or an employer and, pursuant to that arrangement, reinsures that contract with an insurance company (or a reinsurance company) affiliate of the employer does not fall within the purview of that class exemption.

The IRS’s Analysis

The IRS focused its analysis on the question of whose risk is being insured by S1 – specifically, X, the VEBA, or the covered retirees and their dependents. In this instance, the IRS determined that the risks being indemnified by S1 are the covered retirees’ and their dependents’ risks of incurring medical expenses during retirement due to accident and health contingencies. In making this determination, the IRS appears to have viewed the following facts as determinative:

- Although the VEBA entered into Contract A, the covered retirees’ health insurance is an economic benefit to the retirees because it relieves them of the expense of buying health insurance for themselves and their dependents. Cf. Rev. Rul. 92-93, supra ("This insurance on the employees’ lives is an economic benefit to the employees since it relieves them of the expense of providing life insurance for themselves.").
At the time that Contract A goes into effect, neither X nor the VEBA has any obligation to offer health benefits to the covered retirees and their dependents.

Both X and the VEBA may cancel the health benefits coverage at any time.

Taking this analysis into account, the IRS concluded that the risks under Contract B are insurance risks, and that Contract B constitutes “insurance” for federal income tax purposes. Furthermore, because Contract B is S1’s sole business, it constitutes more than half of the business performed by S1 for the taxable year. Accordingly, the IRS also ruled that S1 qualifies as an “insurance company” for the taxable year under the definition of that term provided in IRC § 816(a) because more than half of its business during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Sutherland Observations

1. The IRS’s analysis confirms the continuing vitality of Rev. Rul. 92-93, supra. In that revenue ruling, the IRS concluded that the parent corporation’s employees should not be viewed as parties that are related to the captive and, correspondingly, that the risks of those employees should be treated as unrelated-party risks for purposes of the insurance analysis.

2. It is curious that Rev. Rul. 2014-15 does not discuss Rev. Rul. 2009-26, 2009-38 I.R.B. 366. In Rev. Rul. 2009-26, the IRS looked through a reinsurance arrangement to the risks associated with the insurance policies that were the subject of that arrangement for purposes of determining whether the reinsurance arrangement constituted “insurance” for federal income tax purposes.

3. In focusing its analysis on the question of whose risk is being insured by S1, the IRS assumed the following points of factual significance: (i) S1 is regulated as an insurance company under state law; (ii) S1 possesses adequate capital to fulfill its obligations to IC under Contract B; (iii) Contract B is regulated as insurance; (iv) the amount of premium under Contract B is determined at arm’s length in accordance with applicable insurance industry standards; (v) there are no guarantees that the VEBA or X will reimburse S1 with respect to S1’s obligations under Contract B; (vi) none of the premium received by S1 for Contract B is loaned back to the VEBA or X; and (vii) in all respects, the parties to the arrangement conduct themselves consistent with the standards applicable to an insurance arrangement between unrelated parties. These facts and others typically are taken into account by the IRS in determining whether an arrangement
 constitutes “insurance” for federal income tax purposes and whether a company qualifies as an “insurance company” under the definition of that term provided in IRC § 816(a).

4. Among other issues, Rev. Rul. 2014-15 does not address (i) whether the health benefits are provided through a self-insured medical reimbursement plan for purposes of the nondiscrimination rules under IRC § 105(h), (ii) the deductibility of a contribution by X to the VEBA, (iii) certain issues that would arise if an employer provides welfare benefits other than through a VEBA, or (iv) whether S1 qualifies as a “life insurance company” for the taxable year under the definition of that term provided in IRC § 816(a).

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