



CAPTIVE INSURANCE UPDATE
*** * * NEWS FLASH * * ***

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**RECIPROCAL INSURANCE COMPANIES:
AVOIDING POTENTIALLY COSTLY ERRORS IN ISSUING
NOTICES OF SUBSCRIBER SAVINGS ACCOUNT ALLOCATIONS**

INTRODUCTION

This News Flash edition of the Downs Rachlin Martin PLLC (“DRM”) *Captive Insurance Update* outlines the requirements for a reciprocal insurer to report annual allocations of income that the reciprocal makes to subscriber savings accounts. If the reciprocal qualifies as an insurance company for federal tax purposes, it can deduct these allocated amounts from its federal taxable income and thereby save on federal income taxes. To qualify for the deduction, however, the reciprocal must comply with rules set forth in the federal Treasury Regulations regarding notification to subscribers of the subscriber savings account allocations. *Failure to follow these rules can result in a disallowance of the reciprocal’s tax deduction of the subscriber savings account allocations.*

RECAP OF RECIPROCAL INSURANCE COMPANY TAXATION

In general, for federal income tax purposes an insurance company is treated as any other corporation—it is subject to tax at graduated rates on its taxable income. For purposes of calculating its taxable income, however, an entity that qualifies as an insurance company for federal tax purposes follows a special set of rules found in subchapter L of the Internal Revenue Code of 1986 (the “Code”). Qualification as an insurance company requires that the company’s insurance program have sufficient risk shifting and risk distribution, along with other factors established by the courts and decisions of the Internal Revenue Service (the “Service”).

If an insurance company is formed as a reciprocal insurer and the company qualifies as an insurance company for federal tax purposes, under Code Section 832(f) the reciprocal is allowed an additional deduction for the amount of its annual book income that is allocated to the reciprocal’s subscriber savings accounts (the “SSA”). The subscriber treats the amount of such allocation as a dividend paid or declared for federal tax purposes. As a result, if the reciprocal has tax-exempt subscribers, the reciprocal pays less tax than it would without the Section 832(f) deduction, and the tax-exempt subscriber is not taxable on the allocated amount.

REQUIREMENTS FOR REPORTING ALLOCATIONS

Under Section 832(f), the reciprocal can deduct the SSA allocation only if: (i) the allocated amount is credited to the subscriber's SSA before the 16th day of the third month following the close of the reciprocal's taxable year; and (ii) the reciprocal is obligated to pay the allocated amount promptly to the subscriber if the subscriber terminates participation in the reciprocal at the close of the reciprocal's taxable year. If the reciprocal's taxable year ends on December 31, the allocation must be made by March 15 of the following year.

Section 1.823-6(c)(v) of the Treasury Regulations more specifically sets forth the requirements for the timing and content of the SSA allocation notices:

Every reciprocal underwriter or interinsurer claiming a deduction for amounts credited to the subscriber SSAs must mail to each such subscriber written notification of:

- (i) the amount credited to the subscriber's SSA for the taxable year;
- (ii) the date on which such amount was credited;
- (iii) the date on which the subscriber's right to such amount first would have become fixed if such subscriber had terminated its contract at the close of the company's taxable year; and
- (iv) the notification must be mailed before the 16th day of the third month following the close of the reciprocal's taxable year for which the amount was credited.

CONSEQUENCES OF NOT PROVIDING REQUIRED NOTICE ON A TIMELY BASIS

If a reciprocal insurer fails to provide the required SSA allocation notices to subscribers on a timely basis, the consequences are potentially severe. According to Treasury Regulation Section 1.823-6:

Where for any taxable year a reciprocal . . . claims a deduction . . . and fails to give notice as required . . . , such deduction shall not be allowed unless the reciprocal establishes to the satisfaction of the district director that the failure to mail such notice within the prescribed period was due to reasonable cause.

The potential loss of the Section 832(f) deduction would be especially significant for a reciprocal insurance program that includes only tax-exempt subscribers, as the reciprocal would likely have a federal tax liability as a result of the disallowance of the deduction. Moreover, as more companies come into compliance with FASB Interpretation No. 48, "Accounting For Uncertainty In Income Taxes" ("FIN 48"), which requires financial statement disclosure of certain tax positions, a reciprocal that does not comply with the requirements for the Section 832(f) deduction may have financial reporting issues even if the Service has not discovered the error. Note that IRS Form 1099-DIV, which corporations commonly use to report dividends paid to shareholders, does not include all of the information required under Treasury Regulation Section 1.823-6 to report an SSA allocation.

We have worked with reciprocal insurers that have had SSA notice compliance issues, and we have obtained a reasonable cause determination from the Service such that a reciprocal was allowed to take the Section 832(f) deduction despite alleged compliance issues. The process can be lengthy and potentially expensive. As in any similar situation, it is best to take measures to assure full compliance with the rules.

If you have any questions about this News Flash or any other captive insurance developments, or to explore how DRM's Insurance Group can help with your captive insurance matters, please contact Practice Group Chair [Kathy Davis](#), [Kevin Moriarty](#), or [David Angus](#) at (802) 863-2375, or at www.drm.com.

DRM'S CAPTIVE INSURANCE GROUP

Vermont is the leading U.S. domicile for captive insurers and RRGs, and DRM has been at the forefront of the U.S. captive insurance industry for 25 years.

DRM is a regional law firm, with offices in Burlington, Brattleboro, Montpelier, and St. Johnsbury, Vermont, Lebanon, New Hampshire, and Plattsburgh, New York. The firm has been serving individuals, businesses, and institutions for more than half a century.

DRM's insurance team advises our insurance clients on all aspects of their operations, including organizational matters for start-up companies, how to adapt or take full advantage of changes in federal and state regulations, and sophisticated risk transfer matters for established entities. Using the right resources drawn from the comprehensive legal services offered by DRM, we help clients solve both simple and complex problems involved in all aspects of the insurance industry:

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- corporate governance
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- securities laws
- domicile selection
- reinsurance matters
- coverage and defense matters
- policy language
- claims-handling procedures
- reciprocal formation and the role of the attorney-in-fact
- sponsored captives with segregated cells
- other routine issues involving alternate risk transfer mechanisms.

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