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Reciprocal Risk Retention Group Receives Favorable Private Letter Ruling from IRS

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This article addresses a recent favorable Private Letter Ruling (PLR) that our client, a non-assessable captive reciprocal RRG, received from the Internal Revenue Service. The RRG, which provides hospital professional liability insurance for its tax exempt subscriber/insureds, sought the ruling on two issues related to subscriber savings accounts (SSAs).

The PLR is the clearest ruling to date regarding the handling, establishment, structure and payment obligations of a subscriber savings account of an insurance reciprocal. Indeed, prior to this ruling, existing reciprocal tax law and guidance was confusing and unclear in many respects.

While the statutory requirements of and specific reciprocal details are beyond the scope of this article, we believe the article entitled "*Twenty Things You've Always Wanted to Know About Reciprocals (But May Not Have Thought to Ask)*" written by Kevin Moriarty and published in the July 2003 edition of the *Risk Retention Reporter* is an excellent resource.

Tax Advantages of Reciprocal RRGs

RRGs formed as reciprocals have a unique tax advantage over other RRGs formed as stock or mutual insurance companies. Internal Revenue Code Section 832(f) and the corresponding Treasury Regulations allow a reciprocal to take a deduction for the amount of its annual statutory net income that is credited to the SSAs. (While this is not exactly technically true, this is how it is commonly understood and how it usually works.) Technically, a reciprocal is entitled to take a tax deduction equal to the increase in its aggregate SSA balances from the current tax year compared to the previous tax year, in an amount that does not exceed the current tax year's statutory income.

The reciprocal is not required to actually make cash payments or distribute the amounts credited to the SSAs, but the deduction for the SSA credits, in effect, allows the reciprocal to zero out its statutory income annually, and effectively eliminate income tax at the insurance company level (with certain exceptions). If the RRG insureds are tax exempt, they are not required to pay tax on the SSA credits. Thus, RRGs can potentially realize significant tax savings when formed as reciprocals.

RRG Faced Uncertainties Prior to PLR

Prior to the PLR, our reciprocal RRG client was faced with the IRS requirement that, in order to take the reciprocal deduction, a reciprocal must "promptly" pay the subscriber the balance of its subscriber savings account when the subscriber terminates its contract. This presented a challenge for our client who was engaged in long tail business where claims can take many year to resolve. Although the IRS definition of "promptly" was ambiguous, a six-month period approved previously was too short to meet the needs of our client.

The consequence of not "promptly" returning the balance in the SSA was that, "no deduction shall be allowed for savings credited to subscriber savings accounts if such savings are not in fact promptly returned to subscribers when they terminate their contracts." Treasury Regulation 1.823-6(c).

IRS Ruling Sought on Two Issues

Our client sought a ruling from the IRS on two issues. First, it wanted its subscribers to be able to transfer their subscriber savings account balance to a third subscriber account where funds would ultimately be returned to the subscribers if they left the reciprocal but over a much longer time period than permitted by the IRS for subscriber savings accounts, i.e."promptly" — the six month period approved previously by the IRS.

Second, given the long-tail business of our client, it sought to extend the six month return period for subscriber savings accounts so as to not put the RRG and remaining subscribers at risk for developing claims and losses following the subscribers withdrawal of capital from their subscriber savings account.

In the PLR, the IRS concluded that this reciprocal RRG is allowed reciprocal and dividend deductions pursuant to Sections 832(f) and 832(c)(11), respectively, of the Code and corresponding regulations in light of the reciprocal's (1) voluntary capital contribution policy process for allowing subscribers to contribute their subscriber savings account distributions to the capital of the reciprocal; and

(2) method and practice of paying the savings credited to its subscriber savings accounts to subscribers that withdraw from the reciprocal.

It also approved payment of subscriber savings account balances over an extended period of time, commensurate with the time the reciprocal expects the majority of claims from a given policy year will be resolved.

Voluntary Capital Contribution Process

The PLR is significant in that the IRS reviewed the reciprocal's capital account structure, including its process of making actual distributions from the subscriber savings accounts to those subscribers that agree to contribute those distributions back to the reciprocal to be accounted for in another subscriber account, and allowed the deductions.

Such a policy can help a reciprocal build and preserve capital that does not need to be returned to subscribers "promptly" under the statutes and regulations because it represents capital contributed to the company by the subscriber from distributions, and not savings that are credited to the subscriber and subject to an 832(f) deduction taken by the reciprocal.

Subscribers are able to transfer their subscriber savings account balances, where the company is required to pay them "promptly" if the subscriber leaves, to an account where the company is not required to pay the subscriber "promptly" and the tax deduction of 832(f) is unaffected. In other words, reciprocals now have a way to protect their capital by simply having the insureds transfer all or part of their subscriber savings account to another reciprocal subscriber account.

Payments to Withdrawn Subscribers

Our client also sought a ruling from the IRS regarding the requirement that a reciprocal "promptly" pay the subscriber savings account balance to a subscriber that withdraws from the reciprocal. Prior to the PLR, the IRS had announced that the payment of a subscriber's savings account to the withdrawing subscriber within six months following the withdrawal from the reciprocal satisfied the "promptly" requirement. Another PLR had a more ambiguous sixty day requirement. But our client was engaged in a long tail business where claims can take many years to resolve.

To require the reciprocal to pay these subscriber savings account balances back in six months put the RRG at substantial financial risk, given the volatile and long-term nature of claims in this business. In fact, one could imagine a scenario where a certain number of the subscribers leave and take a substantial amount of the reciprocal's surplus with them with only six months notice.

The IRS ruled in the PLR that the company could pay subscribers their savings account balances over a period of years commensurate with the time the 'company expects the majority of claims from a given policy year will be resolved,' in this case over a period of four to six years from the date a subscriber terminates its insurance policy. This will result in the reciprocal being able to rely on its subscriber savings account capital and should result in less guess work and more accurate subscriber savings account balances being returned to the subscriber. The IRS should be applauded for adopting this reasonable position.

PLR Affirms Reciprocal's Tax Advantages

Reciprocals offer many advantages. The PLR helps clarify the 'tax' advantage offered by the reciprocal deduction by (1) allowing the deduction where the reciprocal's subscribers voluntarily contribute their subscriber savings account distributions to another subscriber account that is subject to the reciprocal's rules, not the IRS' rules, and (2) extending the six month "promptly" requirement on returning subscriber savings account balances to withdrawn subscribers to a four to six year period that is consistent with the reciprocal's claim resolution period.

As a result, the PLR is important to those RRGs and others that currently operate as reciprocals. Existing reciprocals that take the reciprocal deduction may want to review their subscriber accounts and method of paying subscriber savings account balances to subscribers that terminate their insurance coverage in light of the PLR.

PLR Has Important Implications

The PLR enables the reciprocal taxpayer to make sound business decisions in regards to its capital without fear that its reciprocal deductions will later be disallowed because of the way it has structured its equity accounts or the way it makes payment from its subscriber savings accounts to withdrawn subscribers.

While a PLR is not binding on the IRS except as to the taxpayer that requested and received the ruling and cannot be relied upon by other taxpayers, it nevertheless provides other taxpayers with some indication of the IRS' ruling position on a particular legal issue as applied to a set of facts. The PLR will also be of particular interest to those RRGs that currently operate as a stock or mutual company that may be considering converting to a reciprocal. For our client, the PLR has resulted in substantial tax savings and other benefits.

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