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The Lingering Demise of Tax Exempt Mutual and Captive Insurance Companies

Darryll K. Jones

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> *Tax exempt organizations remain dependent upon insurance as a necessary means of achieving the charitable goal*

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Upon close study of IRC §501(m),[1] one wonders why Congress even bothered to enact the rather superfluous provision. Prior to its enactment as part of the 1986 Tax Reform Act, attaining or maintaining the exempt status of an entity which provided insurance to its exempt parent and other unaffiliated exempt organizations was already a difficult, if not impossible task. Moreover, the ability to deny tax exempt status to captive or mutual insurance companies seemed previously present in IRC §502, the provision denying tax exempt status to feeder organizations.

Nevertheless, recent litigation involving insurance companies seeking tax exempt status indicates that perhaps Congress was correct in codifying what might be referred to as an "insurance feeder" provision. In addition, the current, revenue-driven attempt to tax income earned by foreign captive insurance companies controlled by tax exempt organizations seems to complete the demise of the tax exempt insurance industry. Only with respect to governmental functions and agencies is there still support for the tax exempt insurance company.

Prior to the enactment of IRC §501(m), the issue of whether a group self-insurance pool was tax exempt generally depended upon an analysis of the "substantial purpose" requirement contained in Treasury Regulation §1.501(c)(3)-1(c)(1) which denies tax exempt status to an entity or organization if "more than an insubstantial part of its activities is not in furtherance of an exempt purpose." In addition, Treas. Reg. §1.501(c)(3)-1(e)(1) allows an entity to operate a trade or business as a substantial part of its activities but only "if the operation of such trade or business is in furtherance of the organization's exempt purpose. . . ." Thus, the analysis turned upon whether the selling of insurance constituted an activity which furthered an exempt purpose.

Two cases indicate that the provision of insurance in return for a premium is generally viewed as an activity which does not further an exempt purpose. In *American Association of Christian School Voluntary Employees Beneficiary Association Welfare Plan Trust v. United States*, 850 F.2d 1510 (11th Cir. 1988), the 11th Circuit held that a trust conducted a substantial nonexempt activity by providing insurance to employees of its tax exempt members in exchange for premium payments.[2] The 10th Circuit came to a similar conclusion in *Mutual Aid Association v. United States*, 759 F.2d 792 (10th Cir. 1985), where an unincorporated insurance association sold insurance to its tax exempt members. In both cases, the provision of insurance exclusively to other tax exempt organizations did not change what the courts essentially viewed as commercial activities. Instead, the courts looked to the manner in which the entity or organization sold its insurance, focusing on the similarities with commercial insurance companies.[3]

In addition to the general view illustrated by the cases discussed above, the principal underlying IRC §502 seemed to address whether an organization, the sole claim to exemption of which is the selling of services or products to other exempt organizations, qualified as tax exempt under IRC §501. The principle of IRC §502 is that an otherwise noncharitable purpose is not made charitable merely because it is performed for the benefit of exempt entities or that the profits derived from the activity are paid to exempt organizations. The applicable regulation states:

> [T]he subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.[4]

Clearly the principle that providing

goods and/or services to tax exempt organizations is insufficient, in itself, to obtain tax exempt status under IRC §501(c)(3) or (4) was clearly stated prior to the enactment of IRC §501(m).

Even the preface to IRC §501(m) admits to its superfluous nature. IRC §501(m) provides that an organization described in IRC §501(c)(3) or (4) shall not be exempt if a substantial part of its activities consists of providing commercial-type insurance. In addition, IRC §501(m) provides that if the sale of insurance is insubstantial, it is nevertheless presumptively an unrelated trade or business.

As noted earlier, an organization which sells insurance to other unrelated tax exempt entities is not described in either IRC §501(c)(3) or (4) to begin with, thus apparently making IRC §501(m) unnecessary. Moreover, the rule previously existed that the sale of insurance does not further an exempt purpose, therefore constituting an unrelated trade or business. It is appropriate to recall that a pure captive, that is, one which provides insurance only to its parent organization, is not providing insurance and therefore may qualify as an exempt organization.[5] Hence IRC §501(m) has no effect on pure captives. Finally, the drafters of IRC §501(m) acknowledge, at least implicitly, the superfluous nature of the provision:

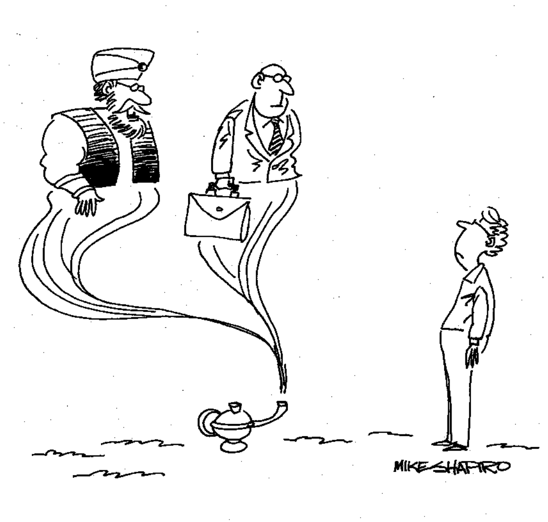
> The providing of insurance benefits by an organization otherwise described in sec. 501(c)(3) generally is considered a commercial activity that does not meet the requirements for tax-exempt status. For example, if two or more unrelated tax-exempt organizations pool funds for the purpose of accumulating and holding funds to be used to satisfy malpractice claims against the organizations, the organization holding the pooled funds is not entitled to tax exemption because the activity (*i.e.*, the provision of insurance) is inherently commercial in nature.[6]

The drafters also acknowledge that a pure captive situation is not a commercial activity and therefore does not endanger IRC §501(c)(3) or (4) qualification, nor is the situation affected by IRC §501(m).[7]

Despite the apparent clarity of the law prior to and even after IRC §501(m), there are three recent cases in which courts were called upon to decide the tax exempt status of organizations providing insurance only to other tax exempt organizations.[8] It is helpful, first though to discuss the reasons for tax exempt insurance pools. With the decline of the doctrine of charitable immunity,[9] charitable organizations have been forced to join the rest of commerce in seeking ways to prevent drainage of resources through tort or casualty loss. Therefore, charitable organizations became subject to the same fluctuating market forces applicable to taxable organizations. These include high or unstable premium costs, untimely cancellations, lack of coverage altogether, lack of control over the insurer, and lack of access to the reinsurance market. As a result, many exempt organizations turned to mutual or pure captive insurance companies for purely nontax reasons. The apparent belief in a tax benefit, as well, merely made a desirable business choice more advantageous.

The judicial response, however, has not been favorable from a tax standpoint. Essentially, a domestic, privately owned captive or mutual insurance company will attain tax exempt status only if it is a pure captive, one that ensures only the risks of its parent and closely affiliated organizations. A captive which provides insurance for a group of unrelated exempt organizations will not attain tax exempt status under IRC §501(c)(3) or (4). In each of three cases decided last year, the entities sought tax exemption because they provided insurance only to other tax exempt entities.[10] Essentially, a mutual benefit corporation owned by or comprised of similar exempt member organizations issued liability or casualty policies exclusively to individual members. In one case, the petitioner argued that in doing so, the corporation furthered the exempt purposes of its member organizations by providing a needed product without the unstable circumstances which sometimes occurred in the insurance market.[11]

Both the Tax Court and the Court of Claims rejected the assumption that the selling of insurance furthered an exempt purpose, in one case stating, "providing insurance to 487 unrelated exempt organizations is not an activity that is vital to each member's exempt purpose. Such a service neither goes to the essence of running each of plaintiff's member organizations nor constitutes an activity which would normally be performed by the member organizations."[12] The courts are not impressed by the fact that mutual or captive insurance companies support the charitable function by reducing overhead costs and thereby making more funds available to the exempt activity. Thus, each court first rejected the initial assumption that the organizations even qualified under IRC §501(c)(3) or (4). Only then did they engage in the extra academic exercise prompted by the enactment of IRC §501(m). In any event, the conclusion seems clear that private insurance pools, even those exclusively servicing



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tax exempt entities, cannot enjoy tax exempt status.

Another insurance pool option which would appear to be in danger is the formation of an offshore captive insurance company. Under this technique, the domestic tax exempt organization creates an insurance company in a foreign jurisdiction. Since the offshore captive is not subject to U.S. taxation, the cost of insurance is less for the domestic exempt organization. In addition, the exempt organization is able to maintain control and thereby alleviate the problems and ills associated with the commercial insurance market. Moreover, if the foreign organization is a pure captive, the domestic parent does not jeopardize its exempt status.[13] Under IRC Subpart F, however, the domestic organization would still realize income, even when the foreign captive makes no actual distributions. IRC Subpart G income, which includes income from the issuance of insurance and certain passive gain, must be realized regardless of whether it is actually distributed to the shareholder. Thus, the domestic tax exempt is treated as realizing income from its captive insurer.

In 1990, the IRS issued a series of private letter rulings in which it considered whether a tax exempt organization realizes unrelated business income from the phantom income attributable under Subpart F. In its initial ruling, the service stated that the income, regardless of its source, was to be treated as a dividend, and therefore excluded from the gross income by IRC §512(b)(1).[14] Later, however, the service stated in Private Letter Ruling 9043039 that the character of the phantom income would be determined by the source from which it was deemed paid.[15] An offshore captive which provides insurance to several unrelated entities and collects real property rental income, for example, would cause the attribution of two forms of income to the parent exempt organization. The first type would be IRC §501(m)(2). The second type of income would be treated as real property rental income, excluded from unrelated business taxable income by IRC §512(b)(3)(A)(i).

It is not absolutely clear that the service's position in Priv. Ltr. Rul. 9043039 is correct, since there is no statutory authority to ignore the separate corporate identities of the parent and subsidiary. As a result, the House of Representatives firmly adopted the "look-through" approach of the Priv. Ltr. Rul. 9043039 as part of the Budget Reconciliation Act of 1989 and the Tax Simplification and Technical Corrections Act of 1994. Neither provision survived to full passage and the current tax bill before the House Ways and Means Committee does not contain the look-through authority.[16] Hence, the service's look-through approach may be subject to challenge.

If the look-through approach of Priv. Ltr. Rul. 9043039 survives, though, the substantial nonexempt treatment of insurance sales under pre- and post-IRC §501(m) analysis, and the presumptively unrelated business income treatment provided by IRC §501(m)(2) would be extended to offshore mutual and captive insurance companies. Although those companies would be jurisdictionally exempt from taxation, they would be placed on par with domestic insurance companies. Therefore, they would be taxed via a levy on the domestic exempt shareholders to the extent they provided insurance for more than just a parent exempt organization and its closely related entities, or engaged in other activities which would be considered unrelated if conducted by the tax exempt parent.

There is yet one other limited instance in which a mutual insurance company can achieve the functional equivalency of tax exempt status. Under IRC §115, income derived from the exercise of an essential governmental function which accrues to a state or political subdivision is excluded from gross income. In Priv. Ltr. Rul. 9436048, public school districts created *X*, an unincorporated nonprofit association which provided workers' compensation insurance to members. If the members were private entities, the association's request for tax exempt status would likely be denied under the analysis discussed above. In the letter ruling, however, the Service stated that "protecting the public school districts that are members of *X* with financial protection against losses is an essential governmental function be-

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cause it is of direct benefit to the school districts themselves." Thus, the income earned by a mutual insurance company exclusively owned by and operated for public agencies can be made economically tax exempt.

Importantly, the ruling seemed conditioned upon the nonparticipation of private interests. Thus, mutual and captive insurance pools are still viable for public agencies, such as universities, public hospitals, or political subdivisions seeking access to stable insurance. It remains to be seen, however, what effect sharing of ownership with private concerns would have on the taxation of the mutual or captive insurance entity.

A jurisprudential comment is appropriate in closing. The enactment of IRC §501(m) does nothing to change the difficulty in achieving tax exempt status of mutual or captive insurance companies, except to the extent enactment confirmed existing law. Yet, tax exempt organizations remain dependent upon insurance as a necessary means of achieving the charitable goal. At the same time they are increasingly subject to the fluctuating insurance market. As a result, groups of similar but unrelated charitable institutions can better achieve their respective charitable purposes if they are allowed to pool resources for the common charitable good. It is therefore unfortunate that Congress would have enacted a provision which presumptively and irrefutably labels mutual or captive insurance as unrelated to any charitable purpose. Although the courts first failed to recognize the potential charitable purpose in exempt organizations providing mutual insurance exclusively for themselves, the enactment of IRC §501(m) only compounded the failure.□

[1] All references are to the Internal Revenue Code of 1986, as amended.

[2] Although the case was decided after IRC §501(m) was enacted, it rested largely upon pre-IRC §501(m) law.

[3] *Mutual Aid Association v. United States*, 759 F.2d 792, at 796 (10th Cir. 1985) ("MAA primarily provides property insurance, an admitted economic activity. MMA treats its surplus and profit as would any mutual insurance company. . .").

[4] Treas. Reg. §1.502-1(b) (1995).

[5] Rev. Rul. 77-316, 1977-2 C.B. 53.

[6] H. Rep. 426, 662-665 (1985), *reprinted in* 1986-3 C.B. (Vol. 2) at 663.

[7] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 583-86 (J. Comm. Print 1987).

[8] *Nonprofits Insurance Alliance of California v. United States*, No. 93-325T, 219; *Florida Hospital Trust Fund v. Commissioner*, 103 T.C. No. 10, 150 Daily Tax Report K-4 (Aug. 5, 1994); *Paratransit Insurance Co. v. Commissioner*, 102 T.C. No. 34, 113 Daily Tax Report K-13 (June 15, 1994).

[9] *See* Caldeira, *Changing the Common Law: Effects of the Decline of Charitable Immunity*, 16 Law & Soc'y Rev. 669 (1982).

[10] *See supra* note 8.

[11] *Nonprofits Insurance Alliance of California*, 219 Daily Tax Report at K-2.

[12] *Id.* at K-7.

[13] Priv. Ltr. Rul. 9407007 (Nov. 12, 1993).

[14] Priv. Ltr. Rul. 8922047 (March 6, 1989).

[15] Priv. Ltr. Rul. 9043039 (July 30, 1990).

[16] H.R. 1121 *reprinted* in 43 Daily Tax Report L-1 (March 6, 1995).