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INSIGHT: Captive Audience: More States Instruct Taxpayers to Include Captive Insurance Companies in Combined Returns

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Recent developments in several key states, including Illinois, New York, Minnesota, and Oregon, will impact many captive insurance companies. These states are moving to include certain captives in corporate income tax combined returns with parents and affiliates. The effect of combination is to tax the captives' investment income and to disallow the deductions for premiums paid to the captives. New York and Minnesota are also using the federal definitions of ''insurance'' to determine whether captive insurance companies are combinable and subject to corporate income tax.

Background

A captive is an insurance company that insures the risk of its parent or affiliate companies. Most insurance companies are subject to federal corporate income tax but are exempt from most states' corporate income taxes (most states impose a tax on the insurers' gross premiums in lieu of the corporate income tax). And most states preclude insurance companies from joining a combined group with non-insurance affiliates.

A non-insurance company may deduct its premium payments to an insurance company for both federal and state income tax purposes. However, the IRS has challenged some captive insurance arrangements as not constituting ''insurance'' and disallowed the parent company's premium deduction. In the resulting litigation, federal courts established that an arrangement qualifies as ''insurance'' for federal income tax purposes if it there is: 1) insurable risk; 2) an insurance policy that meets the common notions of insurance; 3) sufficient risk shifting from the insured to the insurer; and 4) sufficient risk distribution among multiple insureds.

Most states follow state law definitions of ''insurance,'' not the federal income tax definition. For example, two recent Maryland Tax Court decisions found that out-of-state insurers were exempt from the state's income tax because they were ''engaged in the insurance business'' under state insurance law. *Leadville Insurance Co. v. Comptroller of the Treasury*, M.T.C. No. 13-IN-OO-0035 (Md. Tax Ct. Mar. 30, 2017); *National Indemnity Co. v. Comptroller of the Treasury*, M.T.C. No. 14-IN-OO-0433 (Md. Tax Ct. Apr. 24, 2015).

In the last 10 years, more states have attempted to impose corporate income tax on captives, usually by requiring combination with non-insurance companies. In 2007, Maine began subjecting captives to income tax and combined reporting. Me. Rev. Stat. Ann. tit. 36, Section 5102.6.A. In 2008, Massachusetts began combining captives if they did not qualify as insurance companies for federal income tax purposes. Mass. Gen. Laws Ann. ch. 63, Section 32B(c)(1). North Carolina began combining captives in 2011. N.C. Gen. Stat. Section 105-130.5A(j)(2). In 2013, the Indiana Tax Court required UPS to include an out-of-state captive in its Indiana combined income tax return, holding that out-of-state insurers with no Indiana physical presence were combinable because they were not subject to the state's premium tax. *United Parcel Service, Inc. v. Ind. Dep't of Revenue*, 995 N.E.2d 20 (Ind. Tax Ct. 2013). The recent developments in Illinois, New York, Minnesota, and Oregon are the latest examples of this trend.

Illinois

Illinois enacted a new tax bill on July 9, 2017, S.B. 9 (P.A. 100-0022), which now requires insurance compa-

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nies to be included in a combined corporate income tax group with non-insurance companies, effective for tax years ending on or after December 31, 2017. *See* 35 Ill. Comp. Stat. 1501(a)(27)(B).

The statutory change is largely a response to the Illinois Appellate Court's decision in *Wendy's International, Inc. v. Hamer*, 996 N.E.2d 1250 (Ill. App. Ct., 4th Dist. 2013). The Illinois Department of Revenue attempted to include a captive insurance company in a combined corporate income tax group by disregarding the captive as an insurance company. The court held that Wendy's Vermont-based captive insurance company was properly excluded from the Illinois combined group because it was an insurance company for federal income tax and Vermont regulatory purposes. After the statutory change, all unitary captive insurance companies will now be combined, even if they are insurance companies for federal income tax purposes.

Illinois is one of a few states that impose both a corporate income tax and premium tax on insurance companies (instead of only a premium tax), so the combination analysis in Illinois may differ from other states. In December 2017, Illinois issued guidance on how the state will integrate different apportionment rules applicable to insurance and non-insurance companies when they are included in the same unitary group, which uses subgroup schedules and various apportionment adjustments for insurance companies.

New York

New York has a long history of attempting to subject captive insurance companies to corporate franchise tax. Most recently, in *Stewart's Shops*, DTA No. 825745 (N.Y. Tax App. Trib. July 27, 2017), the New York State Tax Appeals Tribunal affirmed the Division of Tax Appeals Administrative Law Judge (ALJ) determination that payments by a corporation to its captive insurance company did not qualify as deductible insurance premiums because the arrangement lacked risk shifting and risk distribution. The taxpayer did not treat the captive as an insurance company for federal tax purposes, and the ALJ determined, after analyzing federal case law, that because the transactions did not constitute ''insurance'' for federal income tax purposes, they were not deductible insurance premiums for New York State corporate franchise tax purposes. The taxpayer appealed to the Tax Appeals Tribunal, which affirmed the ALJ's analysis. The taxpayer appealed further to the New York State Supreme Court Appellate Division, Third Department. That appeal is currently pending and will likely be decided in early 2019. Combination was not an issue in *Stewart's Shops* because most of the tax years at issue preceded a 2009 New York Tax Law amendment that required certain captives to be included in a combined group (and the New York State Department of Taxation and Finance decided not to seek combination for 2009). Importantly, the taxpayer held all of its operations in one parent corporation, which also owned the captive. The outcome likely would have been different if the taxpayer had a parent holding company with multiple subsidiaries (including the captive) below it.

New York adopted unitary combined reporting effective for tax years beginning on or after January 1, 2015, and revised the statutory standard (originally established in 2009) to include certain captive insurance companies in a corporate franchise tax combined group. The New York corporate franchise tax unitary group must include any ''combinable captive insurance company,'' which is a captive that derives 50 percent or less of its gross receipts from premium income. N.Y. Tax Law Sections 2.11; 210-C.2.(b). For purposes of this test, New York Tax Law now defines ''premiums'' as ''premiums from arrangements that constitute insurance for federal income tax purposes.'' N.Y. Tax Law Section 2.11. Thus, New York expressly references the federal insurance company determination, and appears to require federal insurance characterization to avoid captive combination for 2015 forward.

Minnesota

Over the past two years, Minnesota has been working to expand the corporate income tax base to combine certain captive insurance companies. Minnesota enacted an omnibus tax bill on May 30, 2017, H.F. 1, which broadened the range of insurance companies that are subject to corporate franchise tax and combinable with non-insurance companies. The changes are effective for tax years beginning after December 31, 2016. Prior to H.F. 1, insurance companies were generally exempt from corporate franchise tax and could not be combined with non-insurance companies.

Both H.F. 1 and the Minnesota Department of Revenue's 2017 franchise tax filing instructions emphasize that insurers will be taxable and combinable if they do not satisfy the federal income tax definition of an ''insurance company.'' This requirement seems to target certain captive insurance companies.

Additionally, H.F. 1 provides that insurance companies from certain states (those that do not impose a retaliatory tax or exempt Minnesota insurance companies on a reciprocal basis) will be taxable and combinable (even if they are characterized as insurance companies for federal tax purposes). However, the scope of this second provision is unclear and there appears to be contradictory interpretations of the statutory language. For example, at the time of this publication, the Minnesota Department of Revenue's 2017 franchise tax filing instructions state the opposite of the statutory text.

The Minnesota Legislature proposed a bill in March 2018, H.F. 3494, which would have implemented a new provision to determine if a captive insurance company could be subject to corporate franchise tax (retroactive to tax years beginning after December 31, 2016). The provision consisted of two alternative tests, each with two prongs. The provision did not make it past the governor's broad vetoes in 2018; however, it could certainly resurface in the next legislative session.

Oregon

Oregon, like Illinois, is one of a few states that impose corporate income tax on insurance companies doing business in Oregon (which Oregon calls the excise tax). Oregon enacted S.B. 153, which differs from Illinois' new tax bill and confirms that insurance companies generally must file separate income tax returns. However, the Oregon Department of Revenue has taken the position that the separate filing requirement applies only to insurance companies that have a separate Oregon filing requirement, and S.B. 153 does not explicitly overrule this position. S.B. 153 is effective October 6, 2017, and applies to all open tax years.

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Oregon's Legislature drafted S.B. 153 in response to the decision in *Stancorp Financial Group Inc. v. Department of Revenue*, No. TC 5039 (Or. Tax Ct. Jan. 8, 2013), in which the court held that a parent corporation did not have to include dividends received from a subsidiary insurance company in its income tax base, but recognized that there was uncertainty as to whether the subsidiary insurance company's income should be included in the parent's income tax base (essentially taxing that income twice). S.B. 153 preserves the rule that insurance companies must file separate returns if they are doing business in Oregon, clarifies how to separate an insurance company's income from its non-insurance parent company's tax base, and prevents double taxation by allowing the parent company to claim a 100 percent dividends received deduction for dividends from subsidiary insurance companies. Or. Rev. Stat. Sections 317.710(5), (7); 317.715(2); 317.267(2)(e).

Before and after S.B. 153, the Oregon Department of Revenue has maintained the position that an insurer that is not separately taxable in Oregon is combinable with an Oregon taxpayer. This was not an issue in *Stancorp* because the captive was separately taxable in Oregon. However, the Oregon Department of Revenue prevailed on this issue in *Costco Wholesale Corp. v. Department of Revenue*, No. TC 4956 (Or. Tax Ct. July 16, 2012), in which the Oregon Tax Court required Costco to include a unitary insurance subsidiary in its Oregon combined group because the subsidiary was not separately taxable in Oregon. The Oregon Tax Court reasoned that Oregon's separate filing statute only applies to insurers that have an Oregon filing requirement.

Under the plain statutory language in effect at the time, insurance companies were arguably excluded from a combined group whether or not they were separately taxable in Oregon. That argument is even stronger now based on the revised statutory language, which states that out-of-state insurers are excluded from a combined group. *See* Or. Rev. Stat. Section 310.710(7)(a). However, the statute does not resolve the issue in *Costco* because it does not explicitly state that an insurer with no separate Oregon filing requirement must be excluded. Furthermore, the legislative history does not indicate whether the Legislature intends to overturn *Costco*.

The Oregon Department of Revenue has indicated that it will continue combining captives that have no separate Oregon filing requirement. The department published regulations and updated income tax filing instructions, both of which implement the S.B. 153 legislation and incorporate the result in *Costco*. Or. Admin. Rule 150-317-0550(3); Or. Dep't of Revenue, 2017 Corporation Excise Tax Form OR-20 Instructions.

Conclusion

More states are attempting to subject captive insurance companies to corporate income tax, specifically by including them in combined groups with non-insurance company affiliates. States are increasingly tying the state tax treatment of captives to the federal tax treatment. Taxpayers should determine whether their captives are federally qualified, and analyze these state tax developments carefully.

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