Captive Concepts in State Tax Planning

by Charles F. Barnwell Jr.

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In this special report, Barnwell discusses state tax planning opportunities available through the use of captives, such as real estate investment trusts. Barnwell also explores issues related to these corporate structures through the litigation of the quick service restaurant Wendy's.

The topics explored in this article are theoretical. The author takes no responsibility for the planning strategies explored in this article. The author assumes practitioners will evaluate the business context, business purpose, and ethical guidelines in determining whether application of these concepts fit any given fact pattern.

While tax professionals associate the term "captive" with insurance, there are other types of captives state and local tax professionals may encounter.[1] Many states, for example, have enacted special rules to curb perceived abuses associated with captive real estate investment trusts and captive regulated investment companies (with an anti-captive REIT or RIC abuse rule). Although infrequently planners have also used subchapter T cooperatives as captives, the so-called 80/20 company may be considered a form of captive. For purposes of this article, a captive is defined as any special purpose entity that has a special tax status, typically at the federal level. Further, a captive is owned in whole or in part by a parent company or by a member, or members, of an affiliated group. In the area of captives, the awkward or disparate methods of state to federal conformity often result in unintended or unclear authority. In some cases, this lack of clarity leads to remedial legislation.[2] As a consequence, captives may create traps for the unwary but also tax planning opportunities.

Regarding most advanced state income tax matters, it is necessary to understand the risks and rewards in the "captive jungle" at the federal level first.

I. Federal Income Tax Highlights of Various Captive Entity Types

A. Captive Insurance

Life and property and casualty insurance companies, including captive insurance companies, are taxed under Internal Revenue Code sections 831-840. Since life insurance companies are typically not captives, an analysis of captive insurance is typically focused on property and casualty insurance. Small captive insurance companies are allowed an election under IRC section 831(b)(2)(A)(ii) that exempts no more than $1.2 million of earned insurance premiums from income of the captive. The parent and affiliation (the insured) may deduct those premiums as ordinary and necessary business expenses under section 162. In the future, the small captive pays income tax only on investment income. While small captives occupy a significant place in the realm of the captive insurance industry, the state planner is likely more interested in captive insurance companies with larger risks and premiums. Many of the cases and controversies in this area at the state level involve *Fortune* 1,000 companies and other large businesses. These large captive insurance companies are the focus of this article.

Large, diverse companies in the modern U.S. economy, particularly in the financial services world, may own traditional insurance companies. In this sense, the insurance companies are "captive." However, captive insurance companies for state planners are those that primarily insure related-party risk, be it that of the parent or other subsidiaries within an affiliated group. In this regard, the federal concerns are significant, and those concerns cascade to the state level.

Of primary concern is whether the captive insurance company has both risk diversification and risk shifting.[3] Risk diversification deals with the law of large numbers — does the insurance company insure similar risks of a large, diverse group of insureds? Risk shifting involves the transfer of true risk from the insured to the insurer. "Insurance" in

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[1] The term "captive" is pervasive in the insurance industry, including special legislation a majority of states have enacted for captive insurance. In the state tax arena, there are many other examples of captives.

[2] *See, e.g.*, Ala. Code section 40-18-35(c); Ga. Code Ann. section 48- 7-28.4(c); Ind. Code section 6-3-1-3.5(b)(10); and Ky. Rev. Stat. Ann. section 141.010(14)(d).

[3] *Helvering v. La Gierse*, 312 U.S. 531 (1941); *Amerco v. Commissioner of Internal Revenue*, 82 T.C. 654 (1984).

this context seems largely a creature of the judiciary.[4] Much of the controversy is focused on the transfer of risk from a parent company to its captive.[5] For the most part, unless the captive has significant third-party risk, or if the risks the captive has assumed are solely risks of the parent, the company will likely not be respected as an insurance company and, as a consequence, at the federal level, it will not be able to deduct reserves for losses under the subchapter L rules. To the extent the captive is subject to state taxation, the implications are perhaps more profound. First, the captive will presumably not be entitled to deduct loss reserves. But secondly, the captive may lose its insurance company status at the state level and be subject to income tax that it may otherwise escape.

Notwithstanding the requirements for third-party risks, the IRS will allow a deduction for legitimate insurance premiums paid by brother and sister companies to a captive within the affiliated group.[6] The *Humana* doctrine therefore presents a significant planning opportunity at the federal and state levels for the use of a captive insurance company, even if those risks exist solely within the affiliated group.

A final requirement to qualify as an insurance company in addition to the requirements for third-party risk shifting and diversification under IRC section 831(c)is that "more than half of the business . . . is the issuing of insurance or annuity contracts."[7] Therefore, non-insurance business activity conducted by the captive, if significant, could result in the loss of the captive's insurance company status.[8]

B. Captive REITs

REITs are creatures of federal tax law, under IRC sections 856-859 and 860. REITs are typically corporations and are generally entitled to a dividends paid deduction. However, REIT shareholders must include the REIT dividend in their income and are not entitled to the dividend exclusion under section 243(d)(3). To maintain its status as a REIT and claim the dividends paid deduction, a REIT must meet several tests at the federal level:

- the REIT must distribute 90 percent of its income annually;
- the REIT must have 100 shareholders (individuals, corporations, partnerships, or trusts);
- 75 percent of the REIT's assets must be real estate assets;
- 75 percent of income must be real estate income;
- 95 percent of the REIT's income must be from real estate income, dividends, and interest; and
- there can be no ultimate ownership by five or fewer individuals, including a set of attribution rules under sections 542 and 544.

C. Captive RICs

Captive RICs are creatures of federal tax law, under IRC sections 851-855 and 860. Like REITs, RICs may take a dividends paid deduction, but the RIC shareholder must include the RIC dividend in income and is not entitled to a dividends received exclusion under section 243(d)(2). A RIC must meet several tests at the federal level:

- at least 90 percent of the RIC's income must come from investments as capital gains, dividends, and interest;
- RICs must have at least a 90 percent distribution of interest and dividends earned on investments (less expenses) and 90 percent of capital gains net income;
- RICs are required to distribute 90 percent of net investment income to avoid a 4 percent excise tax; and
- RICs cannot hold more than 25 percent of assets in securities of any one issuer or group of issuers controlled by the RIC.

D. Subchapter T Cooperatives

Similar to REITs and RICs, subchapter T cooperatives are entitled to a patronage dividend deduction. Essentially, patronage dividends are profits of the cooperative to be distributed typically on an annual basis. Patronage dividends may be declared and deducted in year 1 (consent dividends) and paid within 8.5 months of the following year. Patrons or shareholders of the cooperative are therefore able to defer patronage income because the cooperative receives the deduction in the year proceeding the year the patron must recognize the dividend.

II. State Considerations and Planning

Over the years, state lawmakers have enacted powerful legislation to thwart the efforts of state tax planning. The focus of first-generation state tax planning was via base shifting, or using transfer pricing and intercompany agreements to shift the tax base out of separate filing states and into unitary or tax haven jurisdictions. This type of planning has eroded to the point of almost no benefit — and often the states' countermeasures create potential risks. For example, a basic tactic was the creation of a holding company, often with a situs in Delaware, in which companies concentrated royalties or other intangible income. But in addition to the assertion of economic nexus, practitioners began to face intangible income addback provisions. Also, over the years, more states have adopted mandatory unitary tax reporting.[9]

[4]*Id.*

[5]In Rev. Rul. 01-31, 2001-26 IRB 1348, the IRS abandoned the economic family theory but continues to disallow insurance status to a captive that merely underwrites risks of its parent.

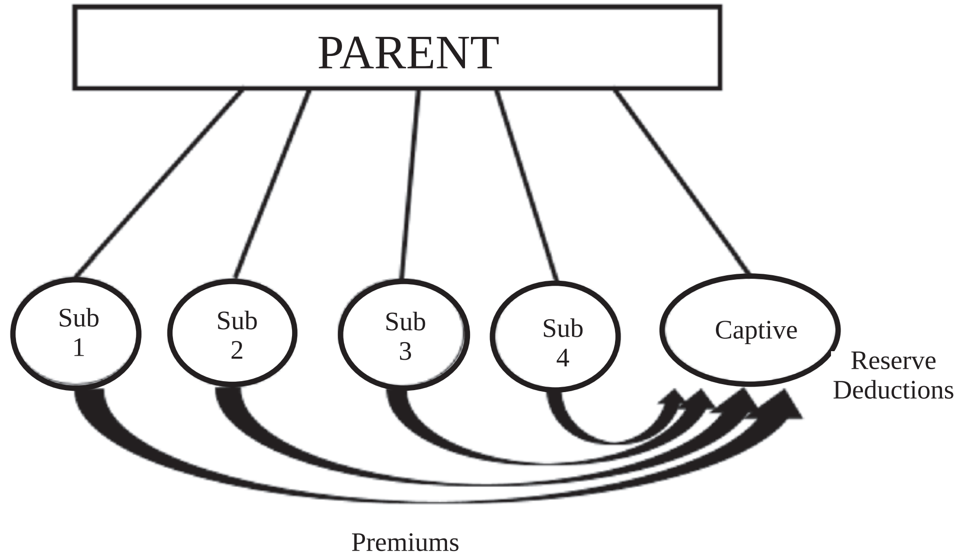
[6]*Humana Inc. v. Commissioner of Internal Revenue*, 881 F.2d 247 (6th Cir. 1989).

[7]IRC section 831(c), incorporating the term "insurance company" as defined under section 816(a).

[8]Foreign captive insurance entities owned by a U.S. parent may avoid an excise tax on premiums by electing to be treated as a U.S. entity under section 953(d).

[9]*See, e.g.*, New York state (but not New York City) requires mandatory unitary combined reporting for years beginning in 2015.

Exhibit 1.
Humana: Brother/Sister Deduction Achieved for State and Federal



To the extent the opportunity for base shifting still exists, realistically, the rate reductions achievable are small if not nonexistent. Further, the complexity presented by ASC 740-10 and the new federal Schedule UTP and the risk that state auditors may request reserve work papers has all but eliminated the opportunity for this traditional type of planning.

Given the erosion of the benefits of base shifting, captives may still present some tax planning opportunity. At the highest level, captives may present a continuing opportunity if implemented with good business purpose. Planning may involve the potential exclusion of the captive and its income from a combined return, sheltering earnings from the captive from income tax, or potentially exclusion of dividends under state rules that may be out of sync with federal rules.

A. Possible Opportunities With Captive Insurance

A captive insurance company, if qualified at the federal level (see discussion above), may escape state income taxation in separate filing and unitary states because it may have so-called in lieu of protection. In many states, because insurance companies pay premium taxes, they are exempt from income tax and other state taxes and fees. Thus, to the extent income may be concentrated in the captive, that income may escape state income taxation.[10] The planner will need to understand whether states other than the state of domicile will respect the out-of-state insurance company's status as such.[11]

In some unitary states, a captive insurance company may not be includable in the unitary group.[12] This may be a result of a state's exclusion of insurance companies or because insurance companies may apportion income under a different method than the standard apportionment formula.[13]

A captive insurance company in a complex corporate group may entitle brother/sister companies within an affiliated group to a deduction at the federal level (see Exhibit 1). In most states, since the starting point in determining state taxable income is federal taxable income, intercompany premiums paid by sister companies within an affiliated group are, in most cases, deductible for state income tax purposes.[14]

A planner may consider transferring intellectual property (or a limited liability company owning intellectual property), or similar property, into the captive, perhaps to capitalize the entity to ensure its ability to pay future claims. To be effective, the planner must consider whether the insurance company, with significant non-premium income, will be considered an insurance company under section 831(c).

[10]For companies in the insurance business, a "reverse captive" may offer a significant means of avoiding income tax. For example, an insurance company with a non-insurance subchapter C entity may consider converting that entity (typically tax-free under IRC section 332) into a wholly owned and disregarded LLC, or really any conduit. In this way, the subsidiary will escape most state income tax.

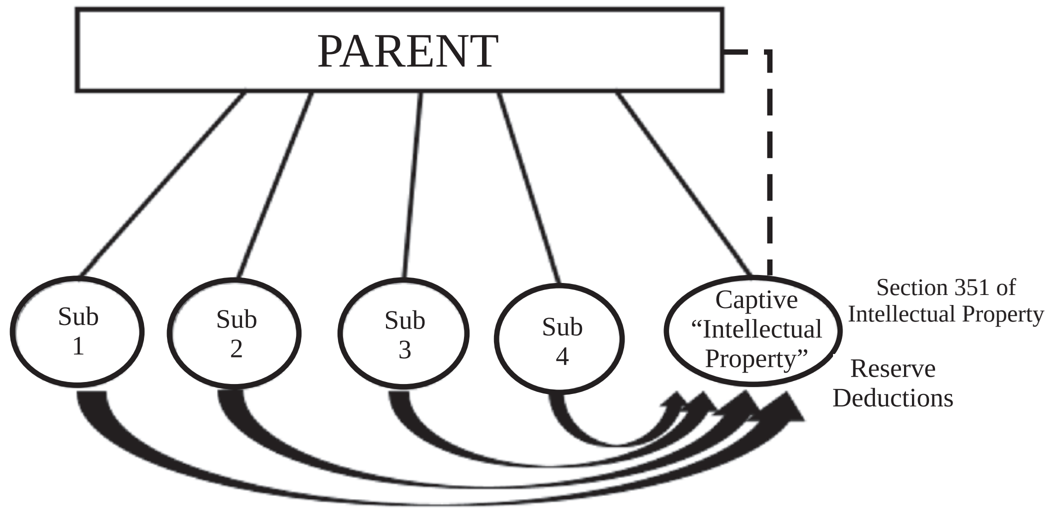
[11]*See, e.g., Wendy's Int'l Inc. v. Hamer*, 996 N.E.2d 1250 (Ill. App. Ct. 2013); *see also* Cal. Franchise Tax Bd., Legal Rul. 385 (Mar. 28, 1975) (insurance companies domiciled in other states are respected as such in California).

[12]*Id.* (insurance companies are not included in the unitary group).

[13]*See Wendy's Int'l*, 996 N.E.2d 1250.

[14]*See Humana Inc.*, 881 F.2d 247.

Exhibit 2.
Humana: Brother/Sister Deduction Achieved for State and Federal Tax Purposes



Refining further, a planner may consider transferring a conduit entity holding intellectual property into a captive insurance company. In theory, this would seem to minimize the risk that the insurance company would not qualify as such under section 831(c), since the royalty income technically accrues to the conduit entity.

Alternatively, a planner may prefer to use a "captive partnership" to ensure the company holding the intellectual property is regarded. If disregarded (that is, the planner uses a wholly owned LLC), royalties and interest attributable to the intellectual property are comingled with insurance premiums for tax purposes. If royalties and interest exceed premium income, it would seem that, for federal (and likely state) purposes, the company would not qualify as an insurance company under section 831(c). Achieving this end is illustrated in the following three-step diagram.

B. Case Study: Wendy's International Captive Insurance

The bad news is that Wendy's International faced at least three battles — in Illinois, Virginia, and Oklahoma — related to its captive insurance company from 2001 to 2007. The good news is that the company's captive insurance structure and strategy were successful in all three cases.[15]

The following discussion is based on Wendy's well-established fact pattern, based largely on the Illinois opinion. Wendy's created a captive insurance company called Scioto to insure various risks of its restaurants — those owned by Wendy's International, as well as franchised restaurant operations in various states.

Those risks included business interruption insurance, including the possibility of an outbreak of bovine spongiform encephalopathy (mad cow disease, coverage for which was apparently unavailable from the insurance market), workers' compensation, and auto liability. Based on the Illinois decision, it appears the IRS respected the captive as an insurance company for federal purposes. We assume the captive had the requisite level of risk shifting and risk distribution as required by *Amerco*[16] and federal case law. Wendy's capitalized the captive by transferring its wholly owned interest in Oldemark LLC into Scioto.[17] Oldemark owned the valuable Wendy's trade name.

1. Illinois Litigation

The Illinois Department of Revenue sought to include Scioto and, due to its disregarded status, the income of Oldemark in Wendy's combined return.[18] For the years under audit (2001 to 2006), Scioto reported income as seen in Exhibit 4.

[15]*See Wendy's Int'l*, 996 N.E.2d 1250; *Scioto Ins. Co. v. Okla. Tax Comm'n*, 279 P.3d 782 (Okla. 2012); and *Wendy's Int'l Inc. v. Va. Dep't of Taxation*, CL09-3757 (Va. Cir. Ct. 2012).

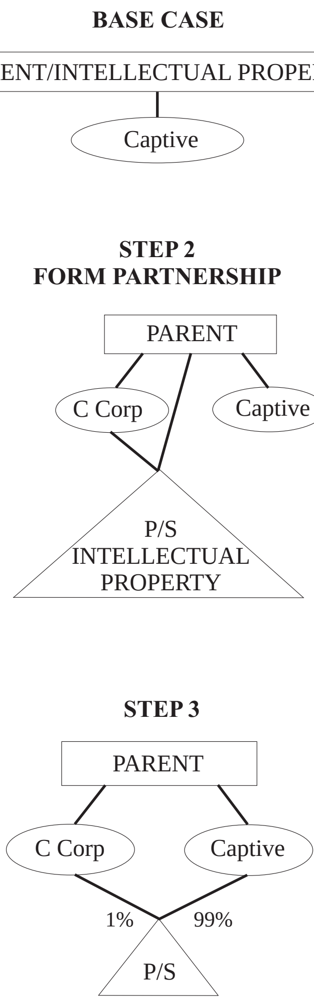
[16]*Amerco*, 82 T.C. 654.

[17]It is unclear whether Wendy's International or Scioto first established Oldemark LLC.

[18]For the years in question, insurance companies used a single factor formula, but the standard apportionment method included a payroll and property factor. Thus, if Scioto was an insurance company,

(Footnote continued on next page.)

Exhibit 3.



Noting the amounts from royalties, presumably accruing to Oldemark, $207 million for the year ended December 31, 2003, to $328 million for the year ended December 31, 2006, as compared with the level of premium income of less than $20 million per year, an initial concern would be whether Scioto would qualify as an insurance company under IRC section 831(c). As noted above, that section requires that "more than half of the business . . . is issuing insurance . . . contracts." However, the Illinois court seems to have looked only to Scioto for this purpose and appears not to have considered the substantial royalty and interest income of Oldemark as "the business" of Scioto. This is particularly interesting given that Oldemark was a wholly owned LLC and thus disregarded for federal income tax purposes. While *Humana* may afford taxpayers a deferral of tax at the federal level, the taxes at the state level are permanent in nature.

Looking at a similar fact pattern for virtually any large company doing business on a multistate basis, it would seem that if one were to assume $100 million in annual royalty income, plus another $25 million in annual interest income, times even a conservative 2 percent rate for all states, the captive structure would generate about $2.5 million a year on a multistate basis. (See Exhibit 4.)

Scioto, Wendy's captive, was domiciled in Vermont, a popular domestic choice.[19] Wendy's may have been concerned as to whether it could "get its intellectual property back" because when Wendy's transferred Oldemark to Scioto, it presumably came within the ambit of the Vermont insurance regulators. Other companies that may consider transferring IP in a similar manner to a captive insurance company may share this concern. However, it appears that Wendy's must have either concluded that it likely would never need to sell or directly own the IP, or that it could always liquidate the insurance company.[20] Transferring valuable IP seems to be a creative way of ensuring adequate reserves for catastrophic claims such as mad cow disease. Interestingly, in a double-down on the state tax deductions, it appears that the royalty income was reloaded to the parent, generating interest deductions for the parent. To accomplish this on a multistate basis in both combined and separate returns is significant.

2. Oklahoma Litigation

In this case, the Oklahoma Supreme Court found that Scioto lacked nexus with Oklahoma.[21] Oklahoma had no connection to trademark and franchise license agreements between Scioto in Vermont and Wendy's International. But why not mention the case of Oldemark? Also, since Oklahoma exempts insurance companies from income tax, why did the taxpayer not use the in lieu of provisions to insulate Scioto from Oklahoma tax?

3. Virginia Controversy

Virginia sought to add back royalty and interest deductions for amounts paid to Oldemark.[22] Virginia has an exception to the addback provisions if one-third or more of

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it could not be combined with Wendy's group because the entities had separate apportionment regimes. (Illinois has since adopted single sales factor apportionment.)

[19] Michael A. DiMayo and Kevin E. Myers, *Discovering Captives: A Guide to Forming and Perfecting Your Own Insurance Company* 24 (2012) ("Vermont became one of the first states in the U.S. to both enact favorable captive legislation and also attract a significant number of captives").

[20] Wendy's ability to liquidate Scioto is outside the scope of this article. No opinion is given on the practicality of, or Wendy's ability to, execute such a plan.

[21] *Scioto Ins. Co.*, 279 P.3d 782.

[22] *Wendy's Int'l*, CL09-3757.

Exhibit 4.

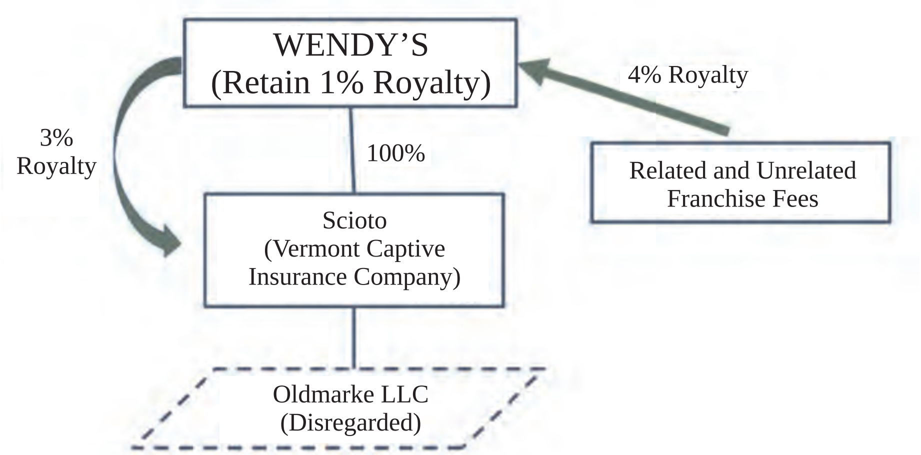
Table 1.
Wendy's International Litigation Outcomes

State	Year of Issue	Court/Agency	Taxpayer Results	Summary of Issue
Illinois	2001-2006	Appellate Court of Illinois	Won	Captive was respected as insurance and excluded from combined return.
Oklahoma	2001-2005	Supreme Court of Oklahoma	Won	Vermont captive held not to have nexus.
Virginia	2004-2007	Circuit Court of the City of Richmond	Won	30% of royalties are from unrelated franchises; exception to add-back applies.
Other States?		No litigation; therefore probably won or settled?		

Table 2.
Wendy's International Profit and Loss
(Including Oldemark LLC)

	Dec. 31, 2001	Dec. 31, 2002	Dec. 31, 2003	Dec. 31, 2004	Dec. 31, 2005	Dec. 31, 2006
Premiums	$18,156,759	$25,059,030	$14,960,726	$18,304,358	$19,526,916	$19,940,927
Royalty Income	$47,157,394	$207,384,178	$217,620,152	$234,470,739	$231,413,458	$327,546,586
Interest Income	$108,757	$5,543,883	$13,772,406	$18,228,723	$27,658,079	$42,566,583
Total	**$65,422,910**	**$237,897,091**	**$246,353,284**	**$271,003,820**	**$278,598,453**	**$389,354,096**

Exhibit 5.
Captive Structure



the intangible expense is paid to third parties.[23] The court ruled that over one-third of the payments derived from licensing trademarks were, indirectly, derived from third-party franchisees. Even though the unrelated franchisee royalties were paid to Wendy's first and then paid by Wendy's to Oldemark, they were nonetheless considered derived from third parties. Therefore, the court found that the exception for third-party payments applied to Wendy's circumstances.

4. Other States

In states with an addback provision for intangible income paid to related parties, would Wendy's be required to add back royalty deductions if paid to an insurance company? It appears likely since the insurance company is likely related under most addback rules, and the addback rules in most states do not appear to carve out insurance companies.

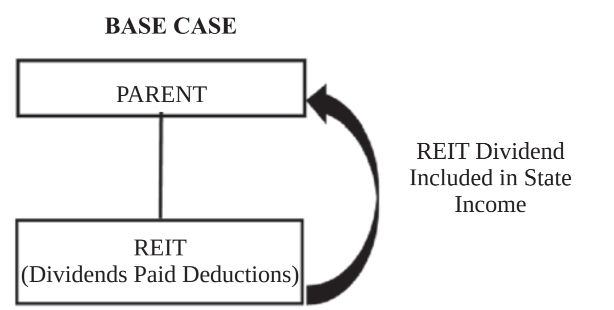
[23]Va. Code section 58.1-402.B.8c.

III. Possible Opportunities With REITs and RICs

A. Basic Captive REIT Planning (and Traps) With Respect to Dividends

Since dividend provisions at the state level vary and may be coupled or treated the same as they are at the federal level, the practitioner may have an opportunity to capitalize on this confusing and disparate landscape. On the other hand, this may create traps for the unwary, particularly in light of anti-captive REIT provisions. Captive REITs are subject to varying rules with varying fact patterns in the multistate realm. As such, the outcomes are myriad.

Exhibit 6.

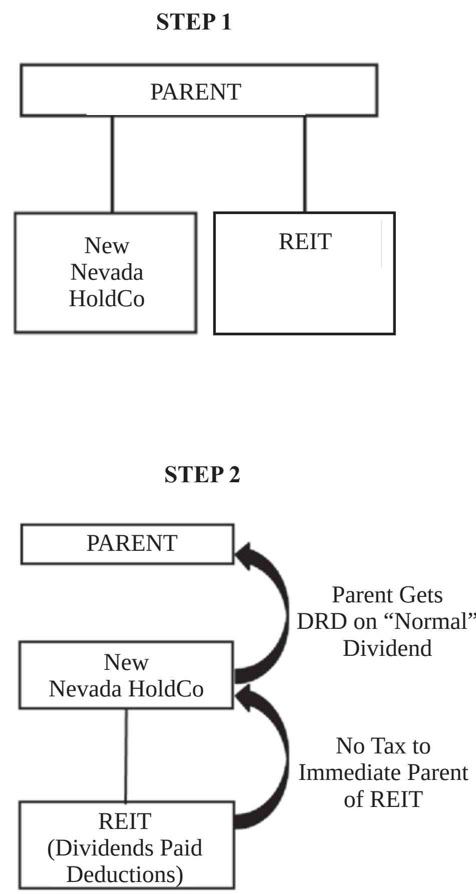


Perhaps the base case for a captive REIT exists in states that allow a dividends paid deduction (like federal law) and require the corporate shareholder to include the REIT dividend in taxable income (Exhibit 6). Assume a real estate subsidiary that would qualify as a REIT operates in a state or states with high tax rates and is owned by a parent in a state or states with low tax rates. In this case, a captive REIT would have the effect of shifting REIT income from the subsidiary to the parent. Planners should evaluate whether a REIT subsidiary opportunity exists in a fact pattern in which a company or group of companies own real estate assets.

Other states disallow the REIT dividend and may presumably allow the corporate shareholder a dividends received deduction, even though the dividend in question is a REIT dividend taxable at the federal level. In this scenario, it would seem the opposite of the case above. If a company has real estate or creates a real estate subsidiary and that subsidiary has a state tax rate that is higher than the rate of its parent, the planner should consider converting the real estate subsidiary into a REIT. The income otherwise taxed at the REIT level is transferred to the parent and taxed at a lower rate.

Another scenario includes transferring a captive REIT (or RIC) into a holding company (Exhibit 7). If the holding company is located in a state that does not tax the REIT (RIC or patronage) dividend, the dividend would potentially escape state taxation.

Exhibit 7.



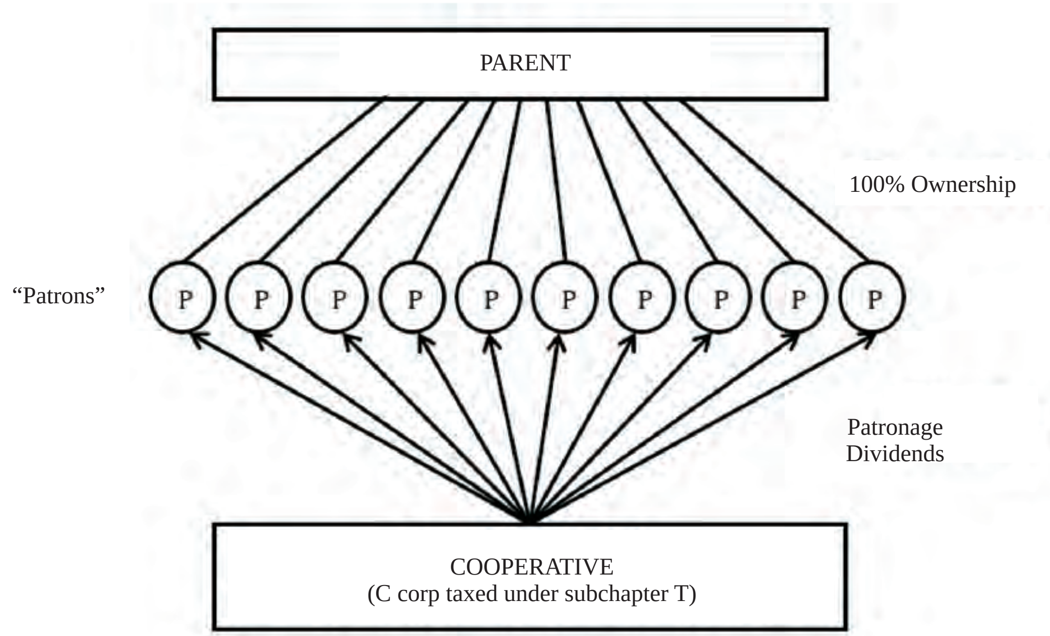
B. Possible Opportunities With Cooperatives

Because subchapter T cooperatives are in a sense "tax cousins" to REITs and RICs, the planning discussed above regarding REITs and RICs may apply to cooperatives. As with REITs and RICs, the question becomes whether patronage dividends are considered dividends at the state level. Alternatively, does the state require patronage dividends from a cooperative to be included in income? What if the patron is based in a state without income tax? Does the dividend from the patron to the parent of the captive cooperative retain its character as a patronage dividend?

Recall that a cooperative may deduct dividends in year one and pay them in year two. Patrons thus pick up the patronage dividend for federal income tax purposes in year two. Thus, a captive cooperative may declare consent dividends and achieve income deferral. That deferral is probably achieved at the state level.

The fundamental captive cooperative would be suited to a company with a complex corporate structure, but one in which subsidiaries are similar in nature (Exhibit 8). For this purpose, perhaps the subsidiaries perform similar business

Exhibit 8.
Captive Subchapter T Cooperative



functions but are geographically delineated (for example, consider a corporate enterprise where each state's operations are in a separate entity).

The planning opportunities are similar to those discussed above for REITs and RICs.

IV. Summary

Captives, unlike many other state income tax planning strategies, continue to offer state practitioners the ability to achieve powerful reductions in tax on a multistate and multi-filing format basis. Notwithstanding increased focus and new antiabuse rules, the landscape remains promising for years to come. ✩