Illinois – Captive insurance company qualifies as an insurance company

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In brief

An Illinois Appellate Court found that a captive insurance company qualified as an Illinois insurance company. The court reasoned that: (1) the company engaged primarily in insurance activities, despite its ownership of a disregarded royalty company; (2) the company was a bona fide insurance company under federal income tax law and was engaged in the necessary risk shifting and risk distribution, even though it solely insured affiliates; (3) there was no evidence that the captive insurance company was formed as a sham or lacked valid business purpose; and (4) in the interests of predictability and conformity, the captive insurance company should be treated as an insurance company in Illinois.

In detail

Facts

In 2001, Wendy's International, Inc. formed a Vermont captive insurance company, Scioto Insurance Company, which insured affiliated entities by providing them workers' compensation, general liability, auto liability, and other coverage Scioto was licensed by Vermont as an insurance company.

To meet Vermont's insurance company capitalization requirements, Scioto owned Oldemark LLC, a disregarded entity that held Wendy's trademarks. Oldemark licensed to Wendy's the right to use and sublicense intellectual property in return for a royalty.

Scioto was included in Wendy's federal consolidated returns. Pursuant to federal audits for 2001-2006, the IRS did not dispute Scioto's status as an insurance company for federal income tax purposes.

During the 2001-2006 tax years at issue, Wendy's treated Scioto as an insurance company that, under Illinois law, could not be included in its Illinois combined return. On audit, the Illinois Department of Revenue asserted that Scioto was not an insurance company and should therefore be included in Wendy's combined return. Wendy's filed a protest with an Illinois trial court, which found in favor of the Department. Wendy's appealed to the Illinois Appellate Court

Illinois treatment of insurance companies

Illinois provides that members of a 'unitary business group' are treated as a 'single taxpayer and generally must apportion income to Illinois together with the income of other members through a unitary combined return. However, insurance companies cannot be included in a combined report with noninsurance companies because insurance companies are required to use special industry-specific apportionment.

Illinois follows federal definition of 'insurance company'

Illinois does not provide a definition of 'insurance company.' However, terms not otherwise identified are given the same meaning as provided under the IRC. For the 2001-2003 tax years, Treasury regulations provided that an insurance company means a company whose "primary and predominant business activity . . . is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies . . . . it is the character of the business actually done . . . which determines whether a company is taxable as an insurance company." For the 2004-2006 tax years, the IRC revised the definition of an insurance company to be "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Income generated from disregarded regarded entity not considered

The Department asserted that Scioto was not an insurance company because the majority of its income, when including Oldemark's income, was derived from intercompany royalty income and not insurance activities.

The court concluded that Scioto's only business was to furnish insurance to Wendy's and its affiliates. Scioto's ownership of Oldemark did not alter this conclusion because (1) Scioto was principally engaged in the insurance business; (2) Scioto was not engaged in the business of licensing intellectual property; (3) Scioto's ownership of Oldemark was directly related to Scioto's conduct as an insurance company because it enabled Scioto to satisfy the capitalization requirements under Vermont insurance law.

The court focused more on the "character of the business actually done by the taxpayer" rather than the percentage of income derived from insurance activity. The court stated that "it would be inappropriate to consider the income generated from Oldemark as coming from Scioto." Accordingly, the court found that Scioto constituted a valid insurance company.

Risk shifting and risk distribution may occur among affiliates

The Department argued that actual risk shifting and risk distribution, required by federal law, did not occur here because Scioto insured risks of affiliates with no insured policyholders outside Wendy's affiliated group.

The court acknowledged that previous case law has held that an arrangement between an insurance company and other affiliates may qualify as insurance for federal income tax purposes. The court held that since Scioto was a provider of insurance contracts and engaged in the requisite risk shifting and risk distribution, it constituted an insurance company for federal income tax purposes as well as for Illinois purposes.

IRS Involvement, Federal Conformity and Vermont Law

One of the issues under consideration in the federal audit was whether Scioto was an insurance company for federal income tax purposes. Under audit, the IRS made adjustments to Scioto's loss reserves consistent with the treatment that Scioto was an insurance company.

Scioto was organized as an insurance company by the State of Vermont and recognized as one by the IRS. The court found that Scioto should be treated as an Illinois insurance company in a similar fashion as it has been treated for Vermont and IRS purposes "considering the advantages of predictability and certainty."

The takeaway

It is likely that the Department of Revenue will seek reconsideration and ultimately appeal the *Wendy's* decision. However, it should be noted that the court held Wendy's met its burden of showing that it was a bona fide insurance company under Vermont law and that the arrangement with its affiliates met the requirements of risk shifting and risk distribution required by the IRS.

Since this case relates to years ending prior to December 31, 2008, it does not address the special Illinois addback requirements that were adopted in 2007 and 2008.

Let's talk

If you have any questions regarding the *Wendy's* decision, please contact:

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