In recent years, interest in reciprocal insurance exchanges has grown as more nonprofit groups have opted for captive insurance as the best means to insure their members without creating taxable income. This article explores the salient aspects of the structure and operation of reciprocals.

Overview of Reciprocals

1. **What is a reciprocal?**

Reciprocals have been around for many years as a risk-pooling alternative to stock or mutual insurance companies. Participants in a reciprocal are known as “subscribers,” which agree to exchange contracts of insurance among themselves and thereby achieve the desired risk pooling. The exchange of contracts is done through an “attorney-in-fact” appointed by all of the subscribers. In general, the attorney-in-fact manages the reciprocal’s finances and handles underwriting, claims administration and investments.

2. **Is a reciprocal a legal entity?**

Yes, but it is not a corporation, partnership or limited liability company. A reciprocal is an unincorporated association formed under a state’s insurance code, which has an identity apart from the subscribers and attorney-in-fact. Some state laws, such as Vermont, explicitly provide that the reciprocal may sue and be sued in its own name. In every captive domicile, the certificate of authority to transact insurance is issued in the name of the reciprocal.

3. **Do the major U.S. captive domiciles allow captives to form as reciprocals?**

Most do. The captive laws of Vermont, Hawaii, South Carolina, and Montana all provide for formation of a group captive as a reciprocal.

4. **Can a reciprocal qualify as a risk retention group?**

Yes. In general, a reciprocal can meet the requirements of the federal Liability Risk Retention Act of 1986 to qualify as a risk retention group. An RRG must be formed as a corporation or “limited liability association.” For a reciprocal to qualify as a limited liability association, a subscriber’s liability for the debts and obligations of the reciprocal is usually limited, generally to the amount of the subscriber’s surplus contribution and some multiple of the premium the subscriber pays to the reciprocal for insurance.

Reciprocal Structure and Operations

5. **What are the reciprocal’s governing documents?**

Each subscriber to a reciprocal executes a power of attorney authorizing the attorney-in-fact to act on its behalf, and an agreement with the other subscribers regarding the powers of the attorney in fact, rights to participate in the reciprocal, governance of the reciprocal and rights to the reciprocal’s funds. Often these provisions are combined into a single subscribers agreement/power of attorney. The subscribers also approve governance rules for the reciprocal, which are comparable to corporate bylaws.

6. **How is the reciprocal governed?**

A reciprocal has a governing board known as the “subscribers advisory committee” (the “SAC”), which has general responsibilities for the finances and insurance activities of the reciprocal, much like the board of directors of a corporation. The subscribers appoint the members of the SAC.

7. **What does the attorney-in-fact do?**

The subscribers agreement/power of attorney often grants fairly broad powers to the attorney-in-fact to conduct the reciprocal’s day-to-day insurance operations. This includes handling funds and financial records and making underwriting and claims decisions. The attorney-in-fact usually has authority to retain third-party service providers to assist with these functions.

8. **How is the attorney-in-fact compensated?**

The attorney-in-fact may be compensated in addition to reimbursement of expenses, with the terms usually set...
forth in the subscribers agreement/power of attorney or
determined by periodic negotiations with the SAC.

As part of the licensing process, the captive insurance
regulators request detailed information regarding third-party contracts and the attorney-in-fact’s
compensation, in part to identify any potential risk that
the attorney-in-fact’s compensation could threaten the
solvency of the reciprocal. This is especially true in large
multi-state programs such as physician liability pro-
grams, in which the attorney-in-fact often exercises
considerable control over all aspects of the reciprocal’s
insurance program and may have disparate bargaining
power compared to a person applying for admission to
the reciprocal as a subscriber.

9. Must the attorney-in-fact provide security for its
obligations to the subscribers?

Yes. This is usually in the form of a bond or other se-
curity of $250,000 or more. Recent legislative changes in
Vermont allow the regulators to waive the bond if the at-
torney-in-fact is affiliated with the subscribers, as might
be the case in a group hospital reciprocal program.

10. Do reciprocals issue insurance policies?

This is the standard practice. The reciprocal statutes
refer to an “exchange of contracts” among the subscrib-
ers, but in general a subscriber is insured in the custom-
ary way through an insurance policy issued by the
reciprocal to the subscriber in exchange for payment of
premium.

11. Are the reciprocal’s subscribers subject to assess-
ment of additional premium under their policies?

Subscribers have a “contingent liability” for the debts
and liabilities of the reciprocal, usually determined based
on premium paid by the subscriber. The reciprocal can re-
quest regulatory approval to extinguish this contingent lia-
bility, so that the insurance policies are non-assessable.
Issuance of non-assessable policies is an important factor
to support a reciprocal’s position as an insurance com-
pany for federal income tax purposes.

Licensing, Surplus and Accounting

12. What are the surplus requirements for reciproc-
cals?

The reciprocal is capitalized through contributions to
surplus by the subscribers. (As non-stock entities, for ac-
counting purposes reciprocals do not have capital.) The
minimum surplus for reciprocal RRGs is usually $500,000
to $1 million, and often higher depending on the recipro-
cal’s insurance program.

13. How does the reciprocal account for the subscrib-
ers’ surplus?

The reciprocal carries two notional equity accounts on
its books for each subscriber. The first is a Paid-in Surplus
Account, which is credited with the subscriber’s surplus
contribution. The second is a Subscriber Savings Account
(“SSA”), to which is allocated a portion of the reciprocal’s
annual operating income or loss.

For accounting, tax and regulatory purposes the
SSAs are treated as equity accounts rather than liabilities
of the reciprocal to its subscribers. The reciprocal may,
however, use funds previously allocated to SSAs to cover
its underwriting and investment expenses and losses. The
reciprocal may make distributions to the subscribers
from time to time, which reduce the balance in the SSAs.
In general, the balance of a subscriber’s SSA is paid to
the subscriber within a reasonable time after the sub-
scriber withdraws from the reciprocal.

Taxation of Reciprocals

14. Are reciprocals subject to state premium taxes?

For state premium tax purposes, reciprocals are
treated as any other captive insurance company. The rec-
ciprocal is subject to a tax on its insurance and reinsur-
ance premiums written. A reciprocal qualified as an RRG
will pay premium tax in its state of domicile and in those
states where the reciprocal is registered to write insur-
ance.

15. Can a reciprocal take a position as an insurance
cOMPANY FOR FEDERAL INCOME TAX PURPOSES?

Yes. But as with any other captive or other insurance
company, being licensed as an insurance company under
state law is not, in itself, sufficient to take a tax position
as an insurance company. The two most important fac-
tors for qualification as an insurance company for federal
income tax purposes are: (i) risk shifting (each insured
must be shifting its risk of loss to the insurer for pay-
ment of a premium); and (ii) risk distribution (there must
be sufficient distribution of independent risks within the
insurance company).

16. If a reciprocal qualifies as an insurance company
for federal income tax purposes, what rules apply?

Insurance companies compute their taxable income
according to the special tax accounting rules found in
subchapter L of the Internal Revenue Code of 1986 (the
“Code”). These rules include provisions regarding ac-
counting for unearned premium, computation of under-
writing losses and gains, and deductions for certain
discounted loss reserves, including reserves for incurred
but not reported losses.

17. Do reciprocals have any special tax advantages
over other insurance companies?

All qualified insurance companies, including reciproc-
cals, are treated as corporations for federal income tax
purposes. Ordinarily this means that insurance company
income is subject to the “double tax” applicable to most
corporations: income is taxed once at the corporate level
and taxed again when distributed to the company’s
shareholders. Insurance companies can deduct amounts
paid as policyholder dividends rather than shareholder
dividends, and thereby distribute earnings free of the
corporate level tax. The insurance company pays a price,
however, in that it must actually distribute funds to take
the deduction.

Reciprocals have a unique tax advantage over other
insurance companies. Code Section 832(f) allows a recip-
allocations is the reciprocal’s “statutory income” as re-

purposes of the SSA allocation deduction? income tax at the insurance company level.

out its taxable income annually, and effectively eliminate reduction for SSA allocations allows the reciprocal to zero income that is allocated to the subscriber SSAs. Unlike the reciprocal to take a deduction for the amount of its annual net income that is allocated to the subscriber SSAs. Unlike the deduction for policyholder dividends, the reciprocal that has an underwriting year different from its taxable year. If, in a subsequent taxable year, the reciprocal changes to an underwriting year that coincides with its taxable year, the change will result in a net operating loss for tax purposes. If the loss can be carried back to the year(s) in which the reciprocal had taxable income, the reciprocal may be entitled to a refund of the tax paid in those previous years.

18. How does the reciprocal determine its income for purposes of the SSA allocation deduction?

The reciprocal’s income that can be deducted as SSA allocations is the reciprocal’s “statutory income” as reported on the annual NAIC Blank. (Note that if the reciprocal completes the NAIC statement based on GAAP accounting, then GAAP accounting is the basis for the determining the “statutory income.”)

The tax accounting rules used to determine the reciprocal’s taxable income are not identical to the accounting rules to determine statutory income. The most significant sources of disparity between taxable income and statutory income are unearned premium, capital losses, and differences between the discount factor used to value loss reserves for book purposes (if any) versus the mandatory discount in loss reserves for tax purposes. These disparities have the effect of decreasing statutory income relative to taxable income. Since SSA allocations are based on statutory income, if the book/tax disparities exist the deduction for SSA allocations will not fully offset the reciprocal’s taxable income before the SSA allocation deduction, and the reciprocal will have a tax liability.

- Capital Losses: For accounting purposes, capital losses are deductible against ordinary income and capital gain; for tax purposes the losses are deductible only against capital gain. Capital losses are usually investment-related, so the limit on deduction of capital losses does not present a significant problem if the reciprocal can realize capital gains. Unfortunately, over the past few years investment losses rather than gains have been the rule.
- Loss Reserve Discount: For tax purposes, unpaid loss reserves must be discounted before they are deducted against underwriting income (this is true of all insurance companies, not just reciprocals). Section 846 sets for the method and rate of discount. If these reserves are not discounted for book purposes, or if they are discounted at a substantially lower rate than the discount for tax purposes, this will increase the reciprocal’s taxable income.
- Reduction in Deduction for Unearned Premium: The computation of a non-life insurance company’s taxable income includes the determination of premiums earned on insurance contracts during the taxable year. “Premiums earned” are defined as gross premiums received (less return premium and premiums paid for reinsurance), plus 80% of unearned premium as of the end of the previous taxable year, and less 80% of unearned premium as of the end of the current taxable year. This 20% discount is the infamous “unearned premium haircut,” which requires an insurance company to take premium deemed unearned for book purposes into income for tax purposes.

The unearned premium haircut is an issue for any reciprocal that has an underwriting year different from its taxable year. If, in a subsequent taxable year, the reciprocal changes to an underwriting year that coincides with its taxable year, the change will result in a net operating loss for tax purposes. If the loss can be carried back to the year(s) in which the reciprocal had taxable income, the reciprocal may be entitled to a refund of the tax paid in those previous years.

19. How do subscribers account for the annual allocations to the SSAs?

Subscribers are required to take the annual SSA allocations into account for purposes of computing their federal income tax liability (similar to a partner in a partnership). Section 832(f) provides that the SSA allocation is treated by the subscriber as a dividend paid or declared by a corporation. If the subscriber is a 501(c)(3) exempt organization, under Code Section 512(b)(1) the dividend is not treated as unrelated business income, so the exempt organization subscriber is not taxable on the SSA allocation. As a result, there may be no federal income taxes at all on the insurance operations of a reciprocal insuring only tax-exempt entities.

20. Considering the tax advantages of reciprocals, shouldn’t every group captive program be organized as a reciprocal?

Not necessarily. If the potential tax advantages are not a paramount concern, the organizers and participants in a group captive program may find it easier to use a stock or mutual corporation. The laws, rules and procedures for governing the participation of shareholders in a corporation are generally better known to group participants, regulators and insurance service providers than the arcane concepts of the reciprocal, the subscribers and the role of the attorney-in-fact.

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