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EXTERNAL ALERT

Illinois Appellate Court Rules in Favor of Captive Insurance Company

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Overview

In *Wendy's International, Inc., v. Hamer*,[1] the Illinois Fourth District Appellate Court recently overturned a trial court ruling and determined that a captive insurance company was an insurance company for Illinois corporate income tax purposes. The ruling is significant because it allowed the taxpayer (Wendy's International, Inc., "Wendy's") to exclude income of the insurance company (Scioto Insurance Company, "Scioto") from Wendy's Illinois unitary corporate income tax returns for calendar years 2001-2006. In this Tax Alert we summarize the appellate court's decision.

Background

Wendy's is the parent company of an affiliated group of corporations in the business of operating restaurants throughout the U.S., including Illinois. After conducting a feasibility study, Wendy's determined that it would be economically beneficial to self-insure its risks. Based upon this analysis, Wendy's formed and licensed Scioto in the state of Vermont as a "captive insurance company" that insured affiliated entities. Scioto insured Wendy's and its affiliated groups based on actuarial determinations. In order to meet capitalization requirements under Vermont insurance law, Scioto acquired Oldemark LLC ("Oldemark"). Scioto owned 100% of Oldemark, which was treated as a disregarded entity for federal and Illinois income tax purposes. Oldemark held Wendy's trademarks, which were licensed for a royalty based on a percentage of gross sales. The royalty income earned by Oldemark was substantially greater than the income that Scioto earned on the insurance premiums.

Wendy's excluded Scioto from Wendy's Illinois unitary business group. Under Illinois law, a taxpayer may not include an affiliate in the Illinois unitary business group if the affiliate is required to apportion its business income under a different subsection of Section 304 of the Illinois Income Tax Act.[2] Under Section 304(b), insurance companies apportion income under a different apportionment method than the method used by restaurants, which apportion under Section 304(a).

The Internal Revenue Service ("IRS") audited calendar tax years 2001 through 2006 and did not dispute Scioto's claimed insurance company status. However, upon audit of the same tax periods, the Illinois Department of Revenue ("Department") issued deficiencies based on its conclusion that Scioto was not an insurance company because: (1) there was not actual risk shifting and risk distribution to constitute insurance for federal income tax purposes, (2) the majority of Scioto's income was derived from intercompany royalty income, and (3) Scioto was not regulated in all states in which it wrote premiums. Wendy's paid the deficiencies and pursued the matter in trial court. As part of the trial court proceeding, Wendy's filed a motion for summary judgment, arguing that it was not required to include Scioto in its Illinois unitary return because Scioto was an insurance company. The Department filed a motion for summary judgment, claiming that Scioto did not meet the definition of an insurance company. In July 2011, the trial court denied Wendy's motion and entered summary judgment in favor of the Department. Wendy's appealed the trial court's decision.

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The Illinois Fourth District Appellate Court overturned the trial court's summary judgment and remanded the case to the trial court for the issuance of an order granting Wendy's motion for summary judgment. In rendering its decision, the appellate court held that Scioto met the federal

[1] *Wendy's International, Inc., v. Hamer*, 2013 IL App (4th) 110678, No 4-11-0678 (Oct. 7, 2013).
[2] 35 ILCS 5/1501(a)(27).

tax law requirements for an insurance company because: (1) "the character of Scioto's business was one of insurance,"[3] (2) the fact that Scioto's income from insurance was "dwarfed by its royalty and interest income" did not undermine its insurance company characterization,[4] and (3) Scioto effectuates "both risk shifting and risk distribution."[5] The appellate court noted further that an insurance subsidiary may qualify as an insurance company "even if there are not insured policyholders outside of the affiliate group, provided the requisite risk shifting and risk distribution are present."[6] Based on the foregoing, the appellate court reversed the trial court and held that "along with the treatment of Scioto by the IRS and the advantages of conformity with federal law, Scioto constituted an insurance company for federal income tax purposes and should have been treated in a similar fashion for purposes of the Illinois Income Tax Act."[7]

Considerations

Taxpayers engaged in the insurance product business should consider the factors relied upon by the appellate court in determining Scioto's status as an insurance company in Illinois. Taxpayers should also consider whether the appellate court's holding may potentially be applicable in addressing other Department challenges of an IRS classification of income or a federal election.

Contacts

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[3] *Wendy's*, slip op. at 7-9, citing *Bowers v. Lawyers' Mortg. Co.*, 285 U.S. 182, 188 (1932) and Treas. Reg. § 1.801-3(a) (2003) for tax years 2001-2003. *See also*, *Wendy's*, slip op. at 9-10, citing I.R.C. §§ 831(c), 816(a) ("The facts indicate Scioto constituted an insurance company . . . .") for tax years 2004-2006.

[4] *Wendy's*, slip op. at 8-9, for tax years 2001-2003 ("Scioto's only business was to furnish insurance . . . . Its ownership of Oldemark . . . does not alter this conclusion . . . . Moreover, 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 also noted that "it is not any percentage of income that determines whether a company is taxable as an insurance company . . . ." *Wendy's*, slip op. at 8, citing *Service Life Ins. Co. v. United States*, 189 F. Supp. 282, 185-186 (D. Neb. 1960). *See also*, *Wendy's*, slip op. at 9-10, ("Scioto was principally engaged in the insurance business during the 2004 to 2006 tax years [and] generated its own business income separate from the income of Oldemark. Thus, it would be inappropriate to consider the income generated from Oldemark as coming from Scioto.").

[5] *Wendy's*, slip op. at 10, citing *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941). In making this determination the appellate court noted that "Scioto was formed for the purpose of providing insurance to Wendy's and its affiliates . . . . Policies were written, and the premiums charged were actuarially determined and reflected fair market rates."). *Wendy's*, slip op. at 10-11.

[6] *Wendy's*, slip op. at 10, citing *Humana, Inc. v. Commissioner*, 881 F.2d 247, 255 (6th Cir. 1989).

[7] *Wendy's*, slip op. at 12. In rendering its holding the court pointed out that "No evidence indicates Scioto . . . was formed as a sham business or lacked a valid business purpose."). *Id*.