Captive Insurance Company Premium Loan Backs: Proper Investment Or Improper Return Of Capital?

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Over the last decade, the use of Captive Insurance Companies ("CIC") has expanded from large entities to smaller, closely held companies, which utilize the IRC § 831(b) election. Correspondingly, the IRS has expanded its review of CIC arrangements, specifically targeting those CIC arrangements that utilize the IRC § 831(b) elections for tax shelter reasons. To date, the vast bulk of IRS audits have focused on the type of insurance provided by a CIC to its insured. In the future, additional IRS investigations may focus on the final transactions between the CIC and its respective owner ("CIC Owner").

With respect to financial arrangements between the CIC and CIC Owner, of particular interest to the IRS are related party loans; specifically, loan backs and circular cash flows. In IRS Notice 2005-49, the IRS requested comments from the captive insurance industry on the characterization of arrangements involving amounts paid as premiums by the CIC Owner to the CIC that are subsequently loaned back to the CIC Owner.

The primary concern of the IRS is that CIC Owners may be enjoying the tax benefits of paying tax deductible premiums to its CIC, and then via a loan back arrangement with its CIC, make use of the same funds without the tax consequences of treating such payments as a dividend. Accordingly, the IRS is likely to designate certain transactions to be a sham, lack economic substance, or even potentially constitute fraudulent criminal tax evasion, if the CIC Owner uses such an arrangement to enjoy tax benefits while simultaneously using funds solely intended for investment in Congressionally-approved investment vehicles. Thus, CIC Owners must ensure that any loan back arrangements or circular cash flows with their respective CIC's constitute bona fide indebtedness in order to avoid these issues.

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Loan Backs

In its simplest form, a loan back arrangement occurs when a payment to a party on one side of a transaction is returned to the payor in the form of a loan. In the captive insurance context, a loan back occurs when a CIC lends money back to a related party, either the entity insured by the CIC or the CIC Owner. Accordingly, a CIC loan back transaction effectively returns premium payments made by an insured back to itself (or the owner of the insured). There are significant benefits to the borrower in a CIC loan back arrangement. A loan back, which is essentially treated the same as a normal loan, is used to invest capital from the CIC back to the insured entity or owner with the goal of avoiding a taxable distribution. A loan (which is fundamentally the same as a loan back) is not considered income to the party receiving the loan because the

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party receiving the loan incurs an offsetting liability—there is no accession to wealth. If the loan were instead treated as a distribution from the CIC, it would either be a taxable dividend (if to the CIC Owner) or a deduction-reducing refund of premium (if to the insured entity), or some combination.

Loan backs, particularly in circumstances that produce a circular flow of income out of a tax deferred investment vehicle, may be considered tax non-compliant (or even fraudulent) where there is no real economic substance to the transaction aside from tax benefits. A finding that a tax scheme has no economic substance will cause the dis-allowance of all claimed deductions. Furthermore, in certain egregious circumstances, a loan back scheme may be deemed an attempt to willfully defraud the United States government out of tax revenue if the IRS determines that the taxpayer never intended to leave proper reserves in place to cover claims.

Circular Cash Flow Fraudulent Loans

All insurance companies must invest company assets to obtain a reasonable return, in order to be able to satisfy future insurance obligations as they accrue. If an insurance company is not able to satisfy future claims, the company may not be considered to truly be providing "insurance." Therefore, in pursuit of reasonable profits, insurance companies may loan funds to others – presumably including making good faith profitable related party loans in certain circumstances. For example, in the life insurance context, policy loans to an insured are very common. However, an IRC § 831(b) CIC is not permitted to serve as a life insurance company. Of course, any loan must be a bona fide loan made in good faith, but a related party loan is inherently subject to intense IRS scrutiny where the possibility of a tax motivation is present.

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Any loan from an insurance company to an insured (or other related party) must be considered bona fide indebtedness to be respected for federal income tax purposes. The IRS has not directly ruled on the definitive factors necessary for such a loan to be deemed "bona fide", but it has issued guidance that indicates that related party loans in the captive insurance context are disfavored. In Rev. Rul. 2002-89, the IRS described a situation in which a captive insurance arrangement would be deemed to be "insurance", provided certain circumstances were met. While the main determinative factor was the risk shifting and risk distribution, the IRS also stated as a presumptive fact that the CIC not make loans to a CIC Owner ("parent" in this case). The IRS did not explain why this fact is listed as a precursor to a situation that is determined to be "insurance", but the implication appears to be that the presence of CIC loans to its shareholder would be problematic, potentially preventing such a transaction from being deemed to be "insurance". At the very least, the IRS listing of this factor indicates disfavor for these types of CIC related party loans. To overcome such scrutiny, the loans would likely require the terms to be highly substantive and tax motivation must not be the purpose of the loan.

The IRS is likely to scrutinize loan backs for the true net economic impact of the loan, rather than focusing solely on the single interest rate variable. If the overall net benefit of the premium payment and loan back, as a transaction, do not appear to be commercially reasonable, and the tax benefits significantly outstrip any tax due from interest being received by the CIC, then the IRS is likely to deny the tax benefits. Thus, assuming the loan terms are otherwise proper, the tax motivation of the transaction is likely to be a determinative factor.

Sham Transactions and Lack of Economic Substance

The IRS has alleged that an arrangement is a "sham transaction" where the economic activity that is purported to give rise to the desired tax benefits does not actually occur. Under a typical CIC arrangement with no loan backs, the CIC shareholders will be subject to large amounts

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of profit and risk potential. For instance, if the CIC "wins its gamble" and has a great claims experience, the CIC (and thus its shareholders) will have substantial claims underwriting income and will be able to reinvest that underwriting income to produce a very large profit potential. Conversely, if the CIC "loses its gamble" and faces large insurance claims, the CIC (and thus its shareholders) will have substantial losses where the premiums paid to-date do not adequately cover the claimed loss. However, for this arrangement to be economically substantive, the investment in the CIC must actually have risk of loss to offset the tax benefits.

In keeping with IRC § 7701(o)(1), among other requirements, a CIC transaction has economic substance only if the CIC transaction changes the CIC shareholder's position (either directly or via its common-owned insured entity) in a meaningful way apart from the tax benefit. Assuming that the CIC arrangement is run otherwise as a proper insurance company such that the transaction would be substantive apart from the loan back, then the economic substance doctrine analysis would focus solely on the effect of the loan back on the substance of the transaction. The presence of a circular loan back materially changes the substance of the transaction because the ultimate taxpayer shareholder has the loaned back premium payment amounts back in its possession – as if the premium were never paid. Thus, if the taxpayer is in substantially the same position both before and after the entire transaction, except that the CIC arrangement has achieved a significant set of tax benefits, then the IRS may successfully argue that the loan back - if not the entire transaction – fails for lack of economic substance.

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The economic substance problems derived from a CIC loan back are made substantially more difficult where the CIC is thinly capitalized, because its capitalization will be reduced even further by the amount of the loaned capital. A thinly capitalized CIC may face liquidity problems – potentially leading to unpaid creditors or bankruptcy, reducing the likelihood of an insurance contract paying off a claim made. Thus, if a loan back causes a CIC to be so thinly capitalized that the CIC is likely unable to pay claims as they accrue, then the CIC loan back arrangement may be found to lack economic substance. The theory is that long-term loan backs, which cause a CIC to be thinly or under-capitalized, may effectively shift the risk of loss back to the insured entity because under-capitalization increases the CIC risk of insolvency which would diminish the likelihood of future claim payments.

The bottom line is that all CIC loan backs run a risk of violating the economic substance doctrine, but loan backs that produce undercapitalization of the CIC almost certainly do so. If the CIC loan back violates the economic substance doctrine (or other judicial doctrines), there is a potential scenario where the IRS asserts consequences far worse than the non-deductibility of the premium payment. These negative results may include severe civil tax penalties or worse.

CONCLUSION

The IRS may view a loan back or circular cash flow from a tax-deferred investment vehicle as fraudulent since loans are not taxable events. If a CIC Owner is able to make use of funds while enjoying tax benefits intended only for true investment in Congressionally favored investment vehicles, the arrangement may be found to be sham, to lack economic substance, and to even potentially constitute fraudulent criminal tax evasion in exceptional cases. To avoid such consequences, a CIC loan back arrangement must constitute bona fide indebtedness and not otherwise violate the codified and judicial doctrines described above.

This article is the first in a series on IRS tax shelter issues dealing with captive insurance companies. The second article will appear in the July edition.

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