

# The Evolving Tax Environment for Captive Insurance Companies

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# **IRS 831(b) ENFORCEMENT**

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# IRS Judicial Weapons: Anti-Avoidance Rules

- **Substance over form**
- Business Purpose
- The Sham Transaction
- **Economic Substance**
- The Step Transaction

# Substance Over Form

- The **facts** that make up the transaction is its “**form**”.
- The “**substance**” of the transaction is **what is actually below the surface** of the facts, sometimes where such facts are created solely for such substance.
- This **doctrine disregards the form in favor of the true substance** to **disallow** the **tax benefits** generated by the artificial nature of the transaction.

# IRC 831(b) Example

- **IRC 162** deduction for ordinary & necessary expenses, potentially including insurance.
- Assume a **risk pool** is used to create the insurance, & risk is being **kidnapped**.
- An **oil and gas executive** who spends 6 mos in Nigeria needs a kidnapping & ransom policy. A **dentist** in Boulder, Colorado does not.
- The **form is the risk pool, the substance is an unnecessary expense** creating a deduction.

# The Economic Substance Doctrine

Now Codified

- Prong 1: The transaction is rationally related to a **plausible non-tax business purpose**
- Prong 2: The transaction results in a meaningful and appreciable **enhancement in the net economic position** of the taxpayer other than to reduce tax.
- Code: penalties as high as 75% and there is no way to use a tax opinion to use “reasonable cause” as a defense.

# IRC 831(b) Example

## Loan Backs

- **Insured deducts premium paid to CIC. The insured (or its owner) immediately borrows significant funds back out without paying taxes on the money.**
- Rev. Rul. 2002-89, the IRS Manual, and case law indicate such CIC loan backs **are at least subject to strict scrutiny**, and may be prohibited under certain circumstances.
- The IRS has **asked for comments** on the facts & circumstances that would give rise to loan back determinations.
- This issue has come up as a **focus in audits**.
- IRS may challenge as an **improper tax-free distribution**.

# IRC 831(b) Example

## Loan Backs

- **Prong One:** Hard to argue that the transaction is **rationally related to a useful non-tax business purpose**. **If you needed the money enough to have it loaned out shortly after paying it, why did you make the premium payment to start with other than to get the tax deduction?**



# IRC 831(b) Example

## Loan Backs (4 of 4)

- **Prong Two:** Transaction appears that there is **no meaningful enhancement in the net economic position** of the taxpayer other than to reduce tax. Your **position is identical** before and after the transaction with respect to the loaned funds. The **only difference is that you have deducted the premium.**

# IRS Statutory Weapons

- Listed Transaction Designation
- Transaction of Interest Designation
- Promoter Investigations
- List Maintenance Requests
- Criminal Investigations

# Listed Transaction Designation

- IRS can designate a transaction as “listed” and trigger reporting requirements and **potentially severe penalties** for taxpayers and advisors.
- IRS **rarely** does this, so it is usually reserved for transactions that are done across the US among numerous taxpayers.
- IRS **states its position** in the listing notice, and judiciary has taken this designation seriously.

# IRC 831(b) Example

- In early 2000's IRS designated a **captive variant structure** as a listed transaction.
- The IRS **eventually withdrew the listing** on a go forward basis, apparently **in part because the deal was not widespread enough**.
- Given the popularity of 831(b) captives, and the promoter exams that are ongoing, it seems like **only a matter of time** until something becomes a listed transaction.

# Transaction of Interest Designation

- IRS can put a transaction with certain attributes on a sort of “**watch list**” where the IRS thinks the transaction is abusive, but is **not ready to “list”** the transaction permanently.
- Transactions of interest have **similar reporting and penalty attributes** to listed transactions.
- It is up to taxpayers and advisors to keep up with what the IRS posts to this list. There is **no ignorance defense**.

# IRC 831(b) Example

- It would not be surprising to find a captive transaction that involves a captive being used as a tax deductible vehicle to fund some sort of investment, and either (a) severely **overstates coverage costs**, or (b) **improperly distributes risk**, as a transaction of interest.

# Promoter Investigations

- **If IRS finds** several taxpayers who have a **common advisor or pool** that appear to be taking the **same abusive activity**, IRS may **open a promoter examination** of the advisor.
- If IRS determines the advisor is a promoter, IRS may penalize them as such at the close of the investigation.

# IRC 831(b) Example (1 of 2)

- IRS Personnel Statements Include:
  - IRS planning on bringing **“a great many”** CIC cases
  - IRS planning on **“expanding”** promoter exams
  - IRS seems very interested in the **“investments”** as driver for CIC formation & operation
  - IRS concerned with **promotional material** that focuses on tax benefits & investment return
  - IRS **hiring private sector forensic personnel** required for ramping up caseload



# IRC 831(b) Example (2 of 2)

- Forensic audits of taxpayers.
  - IRS will **drill down deep** into a case
  - **Determining issues** that should concern IRS
  - **Common touch points** across other cases
  - Specific professionals or risk pools in common
- Open 6700 promoter examinations of:
  - Risk Pools
  - CIC companies

# List Maintenance Requests

- The IRS can request a list of all clients of an advisor, or pool participants if investigation is of a pool.
- Where IRS has found an offending taxpayer, this tool **allows IRS to quickly locate a large number of potential taxpayers to audit** that may have done the same thing.
- IRS will look for similar touch points among taxpayers to map out the **web of promoters.**

# IRC 831(b) Example

- IRS finds one captive that has risk distributed improperly in a pool.
- IRS will **request the pool** to provide a **list of all participants**, and then will audit some or all of the participants, to see if the pool has improperly risk distributed all its participant captives.

# Criminal Investigations

- CID investigations can now progress **simultaneously** with civil promoter examinations.
- A promoter exam can be referred to CID for potential criminal prosecution.
- This is obviously reserved for the worst actors.
- To date, these cases appear to involve **“pretend we are doing it right” discussions** with taxpayers.

# IRC 831(b) Example

- Criminal warrants issued in cases in several states.
  - Risk Pools
  - Captive professionals
- Grand jury indictment in one advanced case.
  - Clients told better **not to make claims**
  - Promoters focused on tax savings (not insurance)

# Dirty Dozen Listing

- Covering Ordinary or Implausible Risks
- Structured Maximized Premiums
- Poor Actuarial Substantiation
- Excessive Fees Charged to Unsophisticated Taxpayers

# Senate Finance Committee

- Raise premium cap to \$2.2m but **lose 831(b)** qualification if **no more than 20%** of premium from one insured.
- Proposal tabled, while IRS investigates estate planning in captives.
- Sen. Grassley is a very serious opponent to abusive tax avoidance transactions.
- IRS will take investigation seriously.
- **Legislation is likely to result** to curb abuses.

# Where is this Going?

## IRS Investigation Pattern Familiar

- First: targeted forensic audits
- Discover common denominators
- Begin 6700 promoter investigations
- Begin criminal investigations
- Broad based warnings to taxpayers
- **We are here**
- Issue broad based guidance
- Start broad audit program based on guidance



**THE END**

# Recent Cases and Non-Binding Pronouncements From the IRS

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# Carnation and Parental Guarantees

- In Carnation, the parent company capitalized the captive with \$120,000.
- The parent guaranteed the rest on request from the fronting carrier.
- This creates a structural problem; it makes the captive an accounting reserve and not an insurance company.

# Rent-A-Center

- Between 1993-2002, insurance costs increase.
- Aon proposed a captive to lower costs, control risk and obtain new coverages.
- Captive was formed in 2002 with \$8.8 million in capital.
- Captive underwrote deductible reimbursement policies from third party insurer.
- Captive had a deferred tax asset – an accounting issue. The captive requested the parent for a parental guarantee related to the DTAs.

# Rent-A-Center

- Court ruled captive was not a sham and that risk was shifted.
- Guarantee did not vitiate risk shifting
  - Guaranty did not impact captive's balance sheet
  - It did not shift the risk of loss
  - Did not involve an undercapitalized captive
  - Was not requested by unrelated insurer.

# Securitas

- Securitas purchases Pinkerton's in 1999
  - 90,000-100,000 employees
  - 2200-2400 autos
  - Implement captive program to underwrite deductibles of third party coverage.
    - Solid business reasons: captive was cheaper and more efficient than third party coverage. In addition, third party market was hardening
    - Purchase Vermont captive in 2000: primary coverage
    - Form Irish Captive in 2002: reinsurance (25 – 45 entities)

# Securitas

- Acquire Centaur Insurance, a 501(c)(15) captive as part of a larger purchase in the early 2000s.
- Securitas learned that the activation of their captive program could jeopardize Centaur's tax-exempt status. Securitas issues a parental guaranty for the Vermont Captive. This eliminates the 501(c) problem because the Vermont captive is no longer an insurance company for tax purposes.

# Why Does the IRS Release PLRs, ILMs, etc?

- To communicate with practitioners.
- In the captive world, the IRS is essentially saying, “we’re seeing a lot of captives that don’t look or operate like an insurance company.”



# Business and Insurance Risk

- The taxpayer in a recent legal memorandum underwrote two policies for his currency related risk.
  - The first covered losses caused by a decrease in the currency's value. Premiums for this policy were calculated by multiplying the "premium," which was derived from the forward currency markets, by a "policy limit," which was based on previous annual sales.
  - The second policy covered losses caused by an increase in the underlying currency. Premiums were determined by multiplying a "premium amount" against a policy limit. Like the other policy, this premium amount was derived from the forward currency market. However, the policy limit was derived from the company's total debt outstanding.

# What is the Difference Between a Business and Insurance Risk?

- A business risk is a risk of loss so closely tied to an insured's way of doing business that it is not considered to be an appropriate subject of insurance coverage. Such risks are typically addressed as overhead (i.e. the cost of the loss is included in the price of the business's products or services) or as a subject for loss control.

# An Insurance Risk Requires Fortuity

- The event or happening has to be so far out of the insured's control that, no matter what precautions he takes, he cannot prepare for the potential damages.
- It would be foolhardy for insurance companies to sell insurance that would pay for losses strictly within an insured's control...This is the point where the concept of fortuity comes into play. **Insurance is designed to cover the unforeseen or at least unintentional damages arising from risks encountered in life and business:** 1 APPLEMAN ON INSURANCE 2d, § 1.3.

# ILM 201511021

- The IRS first noted that insurance mitigated solely against a "fortuitous" risk, which, according to Black's Law Dictionary, is "a happening that, because it occurs only by chance or accident, the parties could not reasonably have foreseen." The IRS next stated that defining a fortuitous event required answering the following questions:
    1. What are the ordinary activities of a business enterprise?
    2. What are the typical activities and obligations of running a business?
    3. Is the action that might be covered by a policy in the control of the insured within a business context?
    4. Is the economic risk involved a market risk that is part of the business environment?
    5. Is the insured required by a law or regulation to pay for the covered claim?
    6. Is the action in question willful or inevitable?
- ILM 201511021*

# Standard Captive Examples

- Administrative Actions
- Regulatory Change
- Loss of key client

# Harper Test

- (1) Whether the arrangement involves the existence of an "insurance risk";
- (2) whether there was both risk shifting and risk distribution; and
- (3) whether the arrangement was for "insurance" in its commonly accepted sense.
  - Harper Group v. C.I.R. 979 F.2d 1341 (9th Cir. 1992)

# Harper Test

- Whether the arrangement involves the existence of an "insurance risk";
  - Basic to any insurance transaction must be risk....If no risk exists, then insurance cannot be present.  
*Harper*
  - Risk: “The possibility of suffering a harm or loss.”
  - This must be described and underwritten

# Harper Test

- “...whether there was both risk shifting and risk distribution;”
- Risk Shifting: is there a validly formed contract between the insured and the insurer to transfer the risk of loss to the insurer?
  - Offer/acceptance/consideration/detriment
- The test [for insurance] continues to be whether, considering all of the facts, the risk of loss was shifted away from the taxpayer who seeks to deduct insurance premiums. [Clougherty Packing Co. v. Commissioner, 84 T.C. at 957.]



# Harper Test

- Risk Distribution
  - Is the captive a sufficiently large pool of risk such that, in the event of a claim, the insured will not receive a majority of his funds back as an indemnification payment?
  - The concept of risk-distributing emphasizes the pooling aspect of insurance: that it is the nature of an insurance contract to be part of a larger collection of coverages, combined to distribute risk between insureds. *Amerco* 96 T.C. 18,41 (T.C. 1991)
    - Two risk distribution models from PLRs
      - Parent to insurer to captive
      - Parent to captive to captive

# The Harper Test: “whether the arrangement was for “insurance” in its commonly accepted sense.” ILM 201503011

- Is the captive is regulated by the state as an insurance company?
- Does the particular arrangement qualifies as insurance under state law?
- Is the captive is adequately capitalized?
- Is the premium is set under customary insurance industry rating formulas?
- Has the parent guaranteed the captive’s payments?
- Does the documentation underlying the arrangement supports characterization of the arrangement as insurance?

# ILM 201350008. *et al*

- A third set of obviously related memoranda, however, develops the risk distribution requirement. Although the insurance companies were different in every memorandum, each transaction involved the same reinsurance program. To adequately distribute risk, all captives sent a "large percentage" of their risk to a reinsurance pool, which sent an equal amount of premiums and risk back to each captive. **For example, the reinsurance policies contained language providing for experience refunds and experience loss carryforwards, which were to be paid back with interest.** The IRS could not determine whether the captive in each memorandum was a valid insurance company for tax purposes. Regarding the reinsurance contracts, the IRS uniformly stated: **"In particular, we were concerned that the reinsurance agreements between Company and the Pool contained provisions whose net effect might be to negate risk shifting and risk distribution."**

# Post-UPS Subjective Intent Issues

- Early captive structures were formed by insurance people.
- Now, Non-Insurance Professions Involved
  - Estate Planning Lawyers
  - CPAs/Accounting
  - Financial Professionals
    - Series 7/Series 65

# Solving the Problem

- Assume the complete client file will be evidence
- Who starts the discussion and how do they start it?
  - Client
  - Professional
    - Make sure you devote a large percentage of the initial conversations to insurance and risk mitigation
    - Review insurance policies
    - Look at recent cases in the potential insured's industry.
    - “What keeps you up at night?”