Captive Insurance – Playing Between the Lines

Presentation To
Dallas Bar Association
Tax Section

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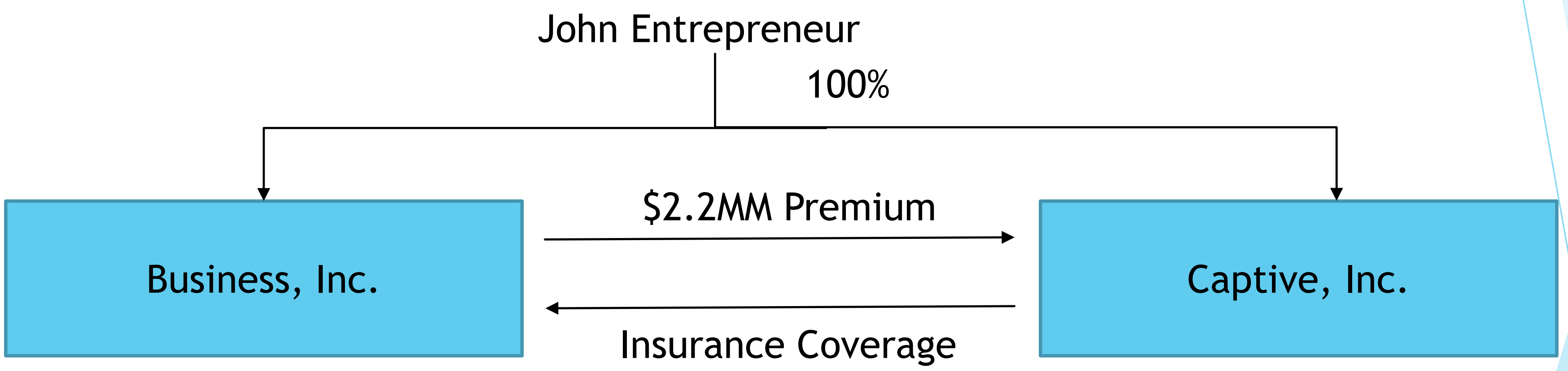
Statutory Underpinnings –

- IRC § 831(a) – Special Deal for NON-Life Insurance Companies
  - Normal Section 11 corporate tax rates imposed on insurance companies EXCEPT FOR <u>non-life</u> insurance companies
- IRC § 831(b) – Extra Special Deal for Small Insurance Companies
  - Eligibility:
    - Must be an insurance company other than a life insurance company
    - Net written premiums for taxable year do not exceed $2,200,000 (1/1/2017)
      - $1.2M in prior years
    - Company elects 831(b) treatment
  - Company only pays tax on its "taxable investment income"
  - Premium income is <u>**tax free**</u>

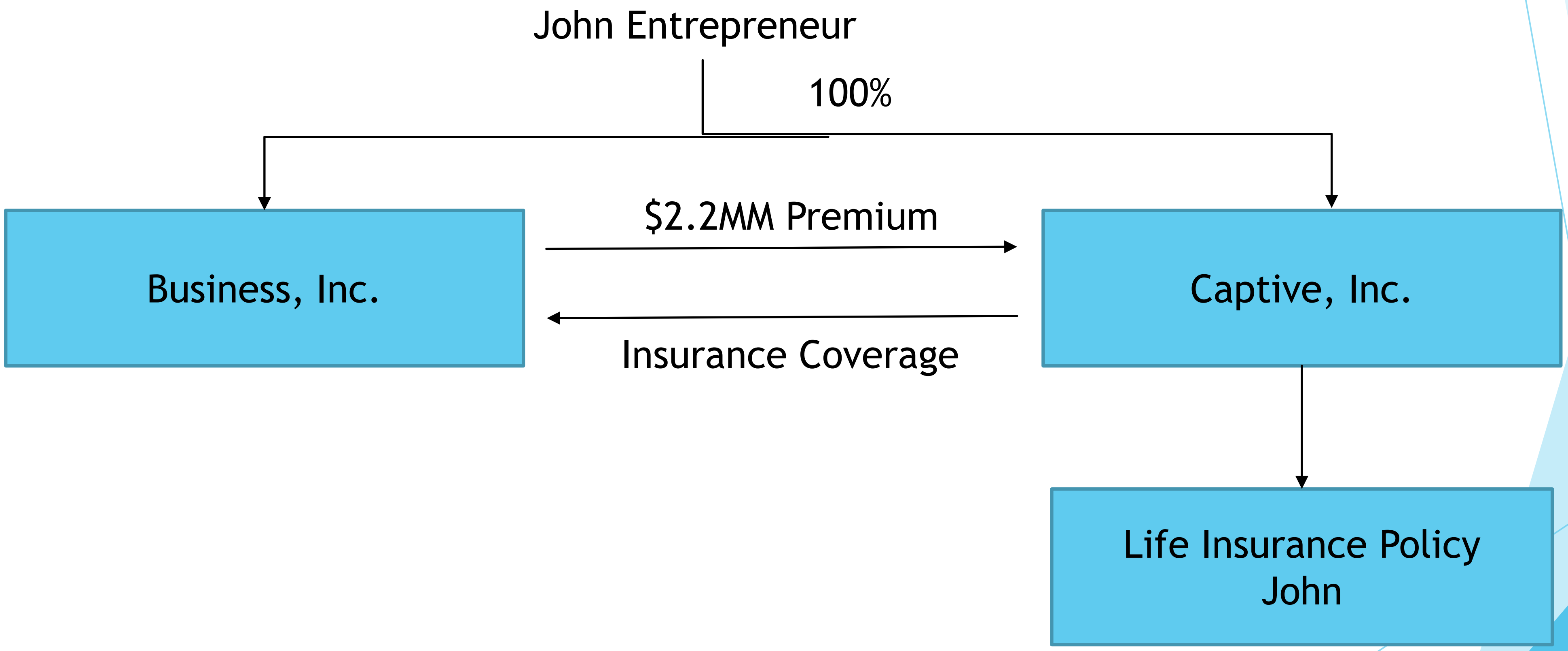
The Initial Game Strategy – The Goal Line

- Client has operating business and is seeking to defer / avoid current income taxes
- Client already pays and deducts normal property, casualty, professional malpractice insurance to mainstream insurer – once paid the funds are gone
- What if you paid the premiums to your own insurance company?
  - You still deduct them (§162) reducing the income tax on your business
  - Under Section 831(b) your insurance company does not pay income tax on the premiums
  - If you do not have a claim against your policy, you still have your money under your control
  - A deduction with no parallel inclusion of income

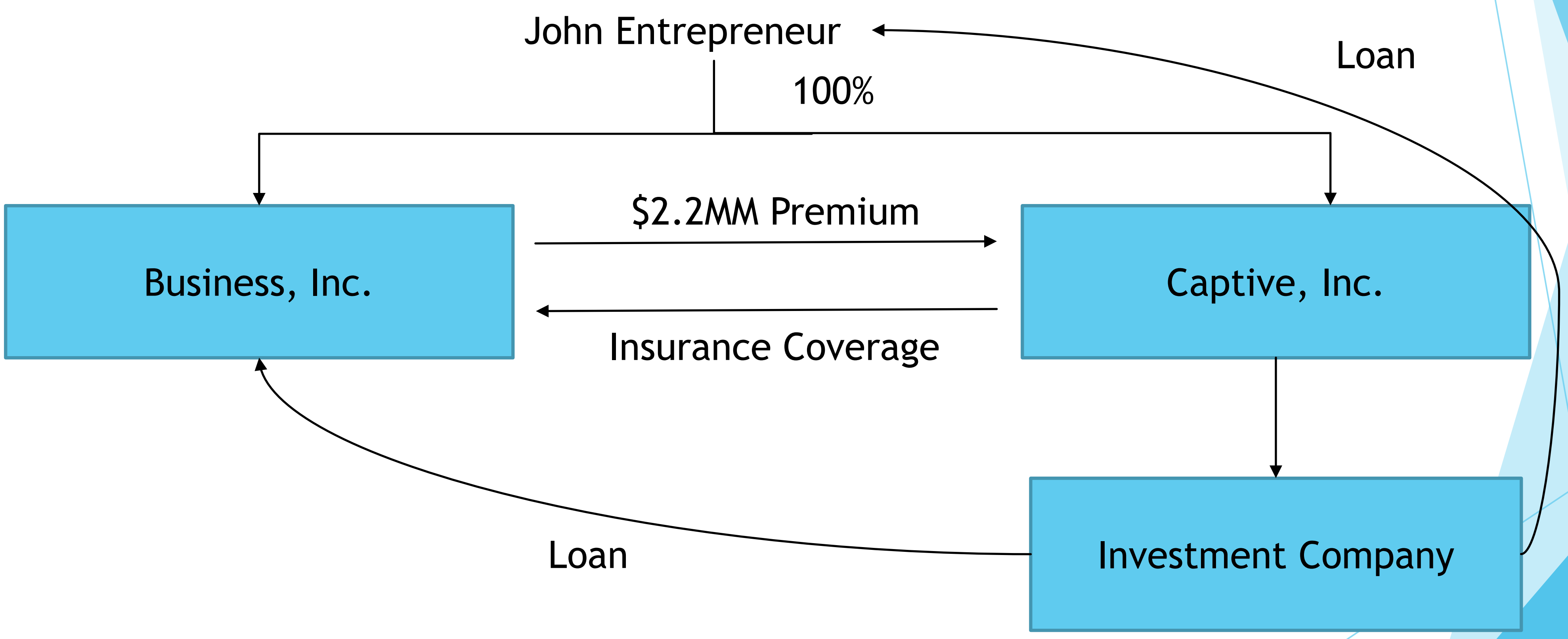
The Structure -



The Structure With Exit Strategy -



The Structure With Exit Strategy 2 -



The Key Issues

- Are the payments “insurance premiums”?
  - What is “insurance”?
- Is the captive an “insurance company”?

The Key Issues

- What is “**<u>insurance</u>**”?
  - No definition in the IRC or Regulations
  - *Helvering v. Le Gierse*, 312 U.S. 531, 539 - 540 (1941)
    - “Congress used the word “insurance” in its commonly accepted sense”
    - “Historically and commonly, insurance involves <u>risk shifting</u> and <u>risk distributing</u>.”

The Key Issues

- **<u>"Risk Shifting</u>**
- "Insurance is an arrangement that must be examined from the perspective of both the insurer and the insured. *** From the insured's perspective, insurance is a risk transfer device, that is, a mechanism by which the insured obtains protection from financial loss by paying the insurer a premium. *** By paying a premium, the insured **externalizes his risk of loss** by shifting that risk to the insurer." *R.V.I. Guaranty Co., Ltd. & Subs.*, 145 T.C. No. 9, slip op. at 26 (2015)

The Key Issues

- **"Risk Distribution**
- "[I]nsurance is a risk-distribution device, that is, a mechanism by which the insurer pools **multiple risks of multiple insureds** in order to take advantage of "**the law of large numbers**." This statistical phenomenon is reflected in the financial world by the diversification of investment portfolios. It is embodied in the day-to-day world by the adage, "Don't put all your eggs in one basket." ***
- Many insureds who pay premiums will not incur losses. Insuring many independent risks in return for numerous premiums thus serves to distribute risk, in effect spreading a portion of the insurer's potential liability among his insureds. *** Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of that claim." *R.V.I. Guaranty Co., Ltd. & Subs., supra* (emphasis added)

The Key Issues

To be insurance you must also have "**<u>insurance risk</u>**" - *R.V.I. Guaranty Co., Ltd. & Subs. v. Commissioner, supra.*

- Requires "<u>uncertainty</u> or, to use a better term, <u>fortuitousness</u>." *Commissioner v. Treganowan*, 183 F.2d 288, 290-291 (2d Cir. 1950)
- **<u>Must not be merely an investment or business risk</u>**. Helvering v. Le Gierse, 312 U.S. 531, 542 (1941); Rev. Rul. 2007-47, 2007-2 C.B. 127; Rev. Rul. 89-96, 1989-2 C.B. 114.

The Key Issues

Examples of **insurance risks** being promoted:

- Risk of Terrorist Attack (excludes cities of 1.5M+)
- Litigation Risk
- Computer Operations and Data Loss
- Business Risk (e.g., lost income due to competitors)

The Key Issues

Is the captive an "**insurance company**"?

- IRC § 816(a) defines "insurance company" as
  - "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"
- Non-Exclusive Factors:
  - (1) the insurer is **adequately capitalized and prices premiums at arm's length**;
  - (2) the insurer was both organized and operated as an insurance company; and
  - (3) the insurer was regulated as an insurance company by the relevant local regulator. *Harper Group v. Commissioner*, 96 T.C. at 60 (1991) *aff'd* 979 F.2d 1341 (9th Cir. 1992); *Kidde Indus., Inc. v. US*, 40 Fed. Cl. 42, 50-52 (1997); Ocean Drilling & Exploration Co. v.United States, 24 Cl. Ct. 714, 728 (1991), *aff'd per curiam*, 988 F.2d 1134 (Fed. Cir. 1993).

History

IRS has not fared well in challenging captives:

Rent-A-Center v. Commissioner – 2014

Securitas v. Commissioner - 2014

Key Pending Tax Court Cases

- *Avrahami, et al v. Commissioner*, Dkt. Nos. 17594-13 and 18274-13
  - Tried in Phoenix, March 2015, Judge Holmes
  - Fully briefed, awaiting decision
- *Wilson, et al v. Commissioner*, Dkt. Nos. 26547-13, 26548-13, 15011-14, 16759-14
  - Tried Phoenix, September 2016, Judge Holmes
  - Briefs Pending

Common thread – NYC attorney Celia Clark

Tax Shelter Attack Methodology – As Yogi Berra said:

“*déjà vu* all over again”

Key Pending Tax Court Cases Audits

- IRS attacks include:
  - Not real insurance
    - Not realistic risks
    - Premiums not realistic
      - Compare to commercial
      - Reverse engineered premiums
    - No risk shifting
    - No risk diversification
    - Step Transaction Money Circle
    - Constructive Dividends
    - Penalties (6662)

Key Pending Tax Court Cases Audits

- IRS attacks include:
  - Not real insurance company
    - Inadequate capitalization (many $250K)
    - Inadequate reserves
    - No claims
  - IRS demands extend statutes of limitations (some 12/31/2018) or Notice of Deficiency will be issued (waiting for Avrahami)

Notice 2016-66: IRS Ratchets up the Scrutiny

Treasury and the IRS believe that micro-captive transactions have the potential for tax avoidance or evasion.

- Taxpayer must disclose (Form 8886) captive transactions if
  - “A,” a person, directly or indirectly owns an interest in an entity (or entities) (“Insured”) conducting a trade or business;
  - An entity (or entities) directly or indirectly owned by A, Insured, or persons related to A or Insured (“Captive”) enters into a contract (or contracts) with Insured that Captive and Insured treat as insurance, or reinsures risks that Insured has initially insured with an intermediary, Company C;
  - Captive makes an election under Section 831(b) to be taxed only on taxable investment income; and
  - A, Insured, or one or more persons related to A or Insured directly or indirectly own at least 20% of the voting power or value of the outstanding stock of Captive.
  - Additionally, either one or both of the following tests must apply:
    - **The 70% Test.** Liabilities for insured losses and expenses are less than 70% of the premiums earned less policyholder dividends paid by Captive.
    - **The Financing Test.** Captive has made available as financing or otherwise conveyed or agreed to make available or convey to A, Insured, or a related person in a transaction that did not result in taxable income or gain to the recipient, such as through a guarantee, a loan, or other transfer of Captive’s capital.

Notice 2016-66: IRS Ratchets up the Scrutiny

- Computation period is most recent 5 taxable years of Captive or if Captive has been in existence for less than five taxable years, the entire period of Captive's existence.
  - If Captive has been in existence for less than five taxable years and Captive is a successor to one or more Captives created or availed of in connection with a transaction described in this notice, taxable years of such predecessor entities are treated as taxable years of Captive.
- Must file Form 8886 by May 1, 2017 (Notice 2017-08)
- Failure to file Form 8886 can subject taxpayer to penalties:
  - 6707A
  - 6662 and 6662A

Are Congress and IRS Headed in Different Directions?