WHAT THE INSURANCE INDUSTRY SHOULD KNOW ABOUT THE IRS'S CAMPAIGN AGAINST "ABUSIVE" MICRO CAPTIVES

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I. Introduction

Though in the midst of a stifling budget and personnel reduction, the United States Internal Revenue Service ("IRS") recently announced an increased effort to curb what it sees as widespread abusive applications of so-called "micro" captives—those that elect under Section 831(b) of the Tax Code to be taxed solely on their investment rather than premium income. Focusing on micro captives is a frugal application of its diminishing resources because the IRS can generate deficiencies against multiple captives and related persons through a single audit of a suspected promoter of abusive schemes. Once the IRS learns how a particular promoter structures its transactions, it can apply that blueprint against all those linked to that promoter. The industry, therefore, should expect and prepare for heightened IRS scrutiny of micro captives over the coming years.

Most perceived "abuses" of micro captives nevertheless comply with the strict letter of the tax rules governing those entities. Thus, rather than search for technical failures, the IRS will assess the substance of the transaction and tax it accordingly. It is insufficient, therefore, merely to "check the boxes" of compliance. Careful planners must take heed of what troubles the IRS

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and be sure to avoid those attributes in new captive arrangements. What follows is a brief overview of the relevant tax rules, followed by a description of the sorts of uses of micro captives that the IRS considers abusive despite their objective compliance with legal standards.

II. Tax Laws Relevant To Micro Captives

An insured's premiums for most types of insurance are deductible as ordinary business expenses under Section 162 and its accompanying regulations. A captive with less than $1.2 million in annual premiums can elect under Section 831(b) to be taxed only on its investment income. The combined effect of these rules allows the money labeled as premiums to go untaxed. While Congress specifically contemplated that outcome, the IRS will challenge any arrangement objectively designed primarily for tax rather than insurance purposes. A regular issue in these cases, therefore, is what qualifies as "insurance," a term that the Tax Code does not define. In *Helvering v. Le Gierse*, the Supreme Court explained that "[h]istorically and commonly insurance involves [both] risk-shifting and risk-distributing . . . That these elements of risk-shifting and risk-distributing are essential to a[n] . . . insurance contract is agreed by courts and commentators." 312 U.S. 531, 539 (1941).

For decades the IRS took the position that risk-shifting and distribution could not occur within the same economic "family," and on that basis, it invalidated captive arrangements between parents and subsidiaries, and brother and sister corporations. Despite some early IRS success, the courts ultimately rejected the IRS's strict view. Following a series of losses, the IRS officially abandoned its economic family theory and acknowledged that, under the right circumstances, brother-sister and parent-subsidiary arrangements could qualify as insurance. In Revenue Ruling 2002-90, for example, the IRS held that a captive insuring the risks of 12 affiliate subsidiaries of the same parent satisfied both risk-shifting and distribution. The IRS's holding was limited to the particular facts before it, including that no one subsidiary amounted to more than 15% or less than 5% of the captive's overall assumed risk. Also notable from the IRS's perspective was the lack of other factors that might otherwise nullify the substantive transfer of risk, such as indemnity, guarantee, or hold harmless agreements. Around the same time, in Revenue Ruling 2002-89 the IRS held that it was acceptable for the captive to assume from its parent less than 50% of the captive's total assumed risk. The IRS also held, however, that where 90% of a captive's total risk stemmed from its parent, such arrangement was not "insurance."

Though recent Tax Court holdings in *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-225 (2014) and *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. No. 1 (2014) might cause the IRS to relax further its application of the risk-transfer and distribution requirements, it has not yet done so, and unless and until it does, one must assume that the IRS will continue to apply these standards. Should a borderline dispute reach the courts, however, no doubt *Securitas Holdings* and *Rent-A-Center* are beneficial to taxpayers, as both tend to deemphasize the importance of number of insureds.

III. Promoted Schemes And Abuses

Though the IRS no longer applies the "economic family" theory, it remains difficult for a captive of a small business to achieve both risk-shifting and distribution. Because small businesses rarely have 12 subsidiaries, affiliated micro captives have no choice but to assume third-party risk. Many captives, therefore, have turned to outside managers to operate the company and secure third-party risk adequate to meet the IRS's exacting standards. From the IRS's perspective, lurking among reputable managers are promoters of "abusive" uses of captives designed primarily to achieve tax savings. But because most promoters design such applications to comply strictly with the Tax Code, the IRS must rely on what is known as "anti-avoidance law" in order to challenge the claimed deductions.

Broadly speaking, and while the semantics differ, the judicial doctrines comprising "anti-avoidance law" hold that technical without substantive compliance with the Tax Code is no compliance at all. Thus, even where a taxpayer ostensibly observes all dictates of a particular law, if the transaction merely fabricates the circumstances necessary to achieve a certain tax outcome, this jurisprudence will disregard the claimed tax consequences. The doctrines allow courts to tax the economic substances of a transaction rather than its technical form. Congress recently codified the "economic substance" iteration of this body of law. *See* 26 U.S.C. § 7701(o). The following are some of the red flags that will suggest to the IRS that a captive and its affiliates have tax benefits as their primary purpose of existence.

"Off Label" Uses. While acceptable to consider some off label uses as fringe benefits, a taxpayer had better be prepared to prove that its primary purpose was insurance. The IRS particularly dislikes when taxpayers use captives to circumvent gift and estate taxes. These taxpayers transfer "premiums" to the captive without taxation and place title of the captive's stock in the names of the intended gift recipients. Other uses include having the captive purchase a life insurance policy on the parent's owner, which effectively allows that owner to deduct otherwise non-deductible life insurance premiums. Under these and other circumstances, the IRS might contend that tax incentives are the primary purpose of the captive.

Substantive Risk-Shifting. Many promoters design their captive arrangements to have only the appearance of risk-shifting and distribution. For example, the parent might purchase a policy on the open market but then have that insurer cede the entire risk to the captive. In other cases, the promoters might create supposed risk pools. On the outside, the captives would reinsure part of the pool's exposure, thereby acquiring third-party risk. But because the prospect of paying third-party claims is not appealing to many, the promoter might have parent corporations indemnify any claims made to the pool. Other common tactics include having excessively high deductibles, which make it unlikely that claims will ever trigger the pool's liability. Though the means used may differ, the common theme is for corporate parents to retain rather than shift their risk, but to make it appear otherwise.

Bona Fide Independence. The IRS will invalidate a captive insurer if the captive is merely a shell rather than a legitimate, independent insurance company. The captive should be adequately capitalized and the formation and policy papers should suggest due diligence by the captive. Similarly, the captive should underwrite all risks and develop a premium defensible under arm's-length market conditions. If the insured fails to pay premiums without consequences, that too will suggest inadequate independence, as will a one-sided claims history. No one fact will be determinative, but the goal should be for it to appear objectively that the parent treats the captive as an independent entity.

"Piggybank" Captives And Implausible Risks. If it suspects that a taxpayer formed a captive primarily to avoid taxation on the amounts paid as premiums, the IRS will look for certain warning signs. One example includes loan backs, where the parent pays premiums to the captive, both sides take their deductions, and the captive "loans" the money back to the parent. At the conclusion of the transaction, the parent retains the beneficial use of the money it paid as premiums, but avoids paying tax on those amounts. Less obvious indicators are captives that invest much or all of their premium income in the parent, affiliates, or in other ways that benefit the parent. Finally, excessive reserves could signal to the IRS that the captive does not function like a truly independent insurance company. In each case, though, capital preservation is the

goal, so any policy claims would be counterproductive. In order to reduce or eliminate that risk, "piggybank" captives might assume implausible risks, especially relative to the premium. When those facts are present, the IRS will suspect that insurance is not the primary motive of the captive. For example, few businesses can reasonably claim to form a captive to insure against terrorism risks. Similarly, a company in the Midwest typically does not view hurricane damage as a reasonably foreseeable peril. Many use such implausible risks to make a captive arrangement appear motivated by insurance, where tax savings are the real prize.

Insurance Risks. A recent Chief Counsel Memorandum concluded that an otherwise sound captive arrangement did not qualify as "insurance" because the policies covered "investment risk" rather than "economic loss." CCA 201511021. The IRS explained that "[n]ot all contracts that transfer risk are insurance policies even though the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk." The IRS continued that "[i]nsurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. A fortuitous event (such as a fire or accident) is at the heart of any contract of insurance." Thus, even if a particular captive arrangement complies with all other requirements, careful planners must be sure that the insured risk is of the variety deemed acceptable by the IRS. No doubt there is a lack of clarity as to where exactly the IRS will draw this line.

VIII. Looking Forward

It is unfortunate that those who abuse the rules led the IRS to create ambiguity and unpredictability for those who do not. To avoid the IRS's ire, a planner should analyze a proposed structure and objectively question whether insurance rather than tax is the true motivation for forming the captive. So long as that is the case, and assuming it complies with all rules, the captive likely will pass IRS muster. Should the IRS select a particular captive and/or parent for audit, however, it is critical that the affected parties immediately hire expert tax controversy counsel to devise an effective strategy with a long-term eye towards potential litigation.

Though the IRS is bent on combatting perceived abuses of micro captives, the Government would be better served treating the cause rather than the symptom. There is some momentum in Congress to raise the annual premium cap to qualify for the Section 831(b) election. While at first blush one might predict that doing so would only lead to more abuse, if done right, the opposite might actually be the case. A primary barrier for micro captives to comply with the *Le Gierse* factors is justifying the trouble and expense of achieving safe harbor risk-shifting and distribution on risk portfolios that can gross no more than $1.2 million per year. That disincentive is what leads many captives to managers, some of whom market the uses disfavored by the IRS. By increasing the amount of income a micro captive can earn, however, the Tax Code might alter that calculation and make it worthwhile for micro captives to navigate the regulatory and legal morass of securing genuine third party risk.

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