CARLTON FIELDS

The Practical Need for Managers of Micro Captives and the Allure of 'Off Label' Uses

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Every tax season, the Internal Revenue Service releases a “Dirty Dozen” list of schemes that it considers abusive and widespread enough to present a systemic threat to its enforcement of the tax laws. This year’s list includes the abusive use of “micro” captive insurance companies. “Micro” captives are those that elect under Section 831(b) of the Tax Code to be taxed solely on their investment income rather than premium income. Such captives are micro because only those with $1.2 million or less in annual premiums qualify for the Section 831(b) election. Couple that deduction with the one available to the insureds for premiums on many lines of coverage, and it is easy to see what is so attractive about using a micro captive. But those attributes also highlight the potential for abuse. The inclusion of captives on the Dirty Dozen list corroborates anecdotal evidence that the formation of micro captives has been on the rise, a fact partially attributable to a throng of promoters who have been marketing “off label” uses to high-net-worth individuals and closely held businesses as a way to reduce their tax burdens. The IRS has made clear that it intends to combat these uses aggressively. One could reasonably argue that the IRS has only itself to thank for creating a cookie-cutter regulatory environment nearly requiring an owner of a micro captive to entrust its care and management to a third-party manager. And while there are plenty of reputable managers who operate captives in good faith observance of IRS rules, there also are those who market uses of micro captives that aim to take (arguably) unfair advantage of them and who recklessly expose their clients to controversy with the tax authorities. The following describes those relevant rules, explains why they are not practically applied to micro captives and describes the practical need for managers.

WHAT COUNTS AS 'INSURANCE' UNDER THE TAX CODE?

A captive insurer must provide actual insurance to qualify for the above-described tax code benefits.

Risk-shifting and distribution

The premiums that an insured pays for most types of insurance can be deducted as ordinary business expenses under Section 162 and its accompanying regulations.[1] A captive that qualifies for and makes the Section 831(b) election may also deduct its premiums. To qualify for those tax benefits, however, the IRS must agree that the captive provides actual insurance. The Tax Code does not define the term "insurance." In *Helvering v. Le Gierse*, the U.S. 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."[2] Since this pronouncement, risk-shifting and distribution have dominated much of the analysis, though additional factors have also gained importance. Together, these factors establish a "facts and circumstances" analysis of whether the captive is a bona fide, independent insurer. The considerations include, for example, whether the captive is licensed; whether the premiums charged reflect quality, arm's-length underwriting supported by actuarial principles; whether the captive is adequately capitalized; the quality and independence of claims adjusting; whether premiums and claims are actually paid and paid in a timely manner; and whether the captive uses quality insurance policies and formation papers.[3] The IRS has also said that a contemplated hazard must be an insurance risk as opposed to a typically uninsured risk, such as an investment risk, to qualify as insurance.[4] While the IRS can apply many factors to attack a given captive arrangement, risk-shifting and distribution remain the primary hurdles. Once those hurdles are cleared, the odds that a captive will survive IRS scrutiny increase significantly. Risk-shifting analysis considers whether the insured "transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment."[5] Conversely, risk distribution analysis considers whether the insurer has spread its risk broadly enough to allow "the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim." By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums."[6] Academically speaking, captives can most easily satisfy risk-shifting and distribution requirements by writing coverage for diverse, third-party risks. But this observation demonstrates the inherent tension between the IRS' definition of insurance and the rationale for forming a captive. That is, captives exist to insure the parent, but to easily exist legally they require third-party risk. ***All in the family?***

In the wake of the *Le Gierse* decision, the IRS developed the now-defunct "economic family theory" to target those captive arrangements in which no risk transfer actually took place. The prototypical economic family involves a parent forming a subsidiary captive and then purchasing coverage from it. The risk remains within the same so-called economic family because the parent wholly owns the captive and money simply shifts from one pocket to the other when claims are paid.[7] The IRS has long since abandoned the economic theory. But it continues to target captives whose risks can be attributed wholly to the parent, as these captives fail the *Le Gierse* test. A more nuanced economic family scenario exists when a parent corporation owns brother-sister entities that claim to transfer risk between themselves. These brother-sister entities typically do not own equitable interests in one another, so payment of a claim by one to the other is not offset by a reduction in the value of the claimant's interest in the payor. Given the great degree of variation among these themes, it is difficult to predict what the IRS and courts will deem insurance. ***Modern safe harbors***

The 6th U.S. Circuit Court of Appeals' decision in *Humana Inc. v. Commissioner* set forth seminal precedent that brother-sister arrangements can qualify as insurance.[8] The *Humana* court held that the risk-shifting requirement was met where an insured affiliate owned no stock in the captive, because the affiliate would suffer no negative further financial impact if the captive honored a claim. Twelve years after the *Humana* decision, the IRS abandoned the economic family theory.[9] Soon thereafter, it issued a series of revenue rulings that created much-welcomed safe harbors. For example, the IRS concluded insurance existed where a captive insured the risks of 12 affiliate subsidiaries of the same parent.[10] Each affiliate accounted for no more than 15 percent and no less than five percent of the captive's overall exposure, which allowed adequate risk distribution. Having abandoned the economic family theory, the IRS was also free to define circumstances under which a captive's assumption of its parent's risk would qualify as insurance. The IRS held in Revenue Ruling 2002-89 that a captive may assume from its parent less than 50 percent of the captive's total assume risk. On the other hand, the IRS held that where 90 percent of a captive's total risk stemmed from its parent, such arrangement was not insurance. Though their holdings are limited to their precise facts, these rulings offer valuable "bright line" rules for planners. However, planners should not consider such rules in a vacuum. In both circumstances, the IRS observed that neither of the arrangements included attributes that might nullify the substantive transfer of risk, such as indemnity, guarantee or hold-harmless agreements. Also, no facts suggested that any of the captives lacked independence or were otherwise shams. **TENSION BETWEEN MICRO CAPTIVES AND CURRENT SAFE HARBORS**

A fair question is whether the IRS adequately considered micro captives when creating the safe harbors. There is no doubt the captive of a Fortune 500 company can act like a large, sophisticated and independent insurance company — with hired actuaries, underwriters, adjusters and the like. Such entities have the resources to plan their operations in exquisite detail, and captives write so much coverage that they can easily meet the IRS' exacting standards for risk-shifting and distribution. Moreover, the associated conglomerates are oftentimes large and diverse enough for the captives to show risk-shifting and distribution without having to write a single unaffiliated policy. Conversely, micro captives face a much more difficult time qualifying for the safe harbors. After all, most micro captives have parents that are closely held, small businesses. Such businesses typically have limited resources and expertise. They also typically lack the affiliated risk to allow the captive to write coverage solely within the same economic family. Consider, for example, a closely held construction business entity that wishes to form a captive. While the owners surely have expertise in construction matters, they likely do not know much about running an insurance company. Even if this hypothetical business is not dissuaded by the prospect of wading into such a specialized and highly regulated sector, how could its captive possibly demonstrate adequate risk-shifting and distribution? Closely held businesses typically do not have 12 subsidiaries, so the construction company's captive would have no choice but to assume unrelated risk. But doing so is not as simple as setting up shop and marketing insurance products to the public. In addition, to take advantage of the Section 831(b) election, the hypothetical captive can earn no more than the $1.2 million annual premium cap. What closely held business would expend the time and money to do all this? This is where the IRS has failed. By making the Section 831(b) election available, the Tax Code affirmatively incentivizes the formation of such insurers. Their existence is a reality from which the IRS cannot hide. At the same time, however, the IRS designed the safe harbors with large captives in mind and never bothered to issue guidance on alternatives standards for micro captives. Because the "one-size-fits-all" approach contemplates larger companies, it has a regressive impact on small insurers and has created a regulatory environment that all but requires creative thinking if micro captives are to fit themselves into the IRS' narrow boxes. **USING CAPTIVE MANAGERS TO CREATE RISK-SHIFTING AND DISTRIBUTION**

There is no doubt that these daunting hurdles have caused many to avoid forming much-needed captives. For those with a strong enough need, however, there is a demand for expert assistance in forming and operating successful — and Tax Code-compliant — captives. To meet this demand, there is a market of so-called captive managers and turnkey operations. Such services attract closely held businesses because they allow those businesses to delegate the hassle of creating their captives and ensuring compliance with the IRS' and the host jurisdiction's regulatory framework. Many managers can offer businesses the benefits of their intimate knowledge of the industry. In exchange for a periodic service fee, captive managers actively manage captive insurance companies on behalf of the parent. This arrangement allows a closely held business to be insured without hiring a full-time staff or otherwise being forced to deal with the burdens of operating an insurance company. Capable managers can perform those tasks efficiently and reliably due to the volume of their work. A group of closely held companies may also coordinate the hiring of a single manager to operate a so-called group captive, which insures and is owned by that unaffiliated group of small businesses.[11] "Turnkey" services are similar to and can overlap with managers, but such providers essentially offer "off the shelf" captives for purchase. Just as an affordable boilerplate will offer an attractively easy option to a low-net-worth individual, turnkey services offer an easy option to closely held businesses. Just as surely that there are many reputable managers, there also are those who operate under the guise of management but who really aim to take arguably abusive tax advantage of micro captives and provide only the outward appearance of compliance with IRS standards. Thus, closely held businesses must be wary of those holding themselves out as reputable managers who tout their ability to satisfy the risk-shifting and distribution requirements. A hollow claim in this regard could be fatal to the captive. A common strategy has the insured purchase some of its coverage from a larger pool of risks that the manager oversees. To create the appearance of third-party risk, a manager may structure 12 or more unrelated captives to insure a cross-section of the pool so that each can claim to insure risks unrelated to its parent. Alternatively, a manager may reinsure the pool for a risk commensurate with the policy purchased by the parent insured, in exchange for a separate premium. The manager then treats that risk as third-party risk, which arguably satisfies the IRS so long as the risk accounts for over half of the captive's overall exposure. Ultimately, the goal of either arrangement is to situate the captive within one of the safe harbors delineated by the IRS. Managers can achieve these goals more easily than could a closely held business; this is because managers have access to many insureds, whereas closely held entities have access to only a handful, or even just one. Such strategies are not necessarily abusive, as many legitimate managers employ similar tactics. If the IRS investigates, it will seek to determine whether these arrangements have substance or merely the appearance of substance. Also relevant will be whether the IRS identifies some purpose other than insurance as the captive owner's main drive in forming the Section 831(b) entity. One such purpose specifically highlighted by the IRS is the use of captives as a means to transfer property without triggering estate and gift taxes. If the facts and circumstances suggest that this is the true purpose of a particular captive, the IRS likely would assess tax deficiencies against the captive, its corporate owner and perhaps the individuals who own the parent. Although it is a "chicken or the egg" sort of question, one has to wonder whether the IRS has itself to thank for the rise of these promoters masquerading as reputable managers. *Originally published in Westlaw Journal Insurance Coverage, Volume 25, Issue 44 (September 2015). Reprinted with permission of Thomson Reuters. All rights reserved.* **FOOTNOTES**

1. 26 U.S.C. § 1.162-14(a).
2. 312 U.S. 531, 539 (1941)
3. *See, e.g.,* Rev. Rul. 2002-91, 2002-2 C.B. 991.
4. *See, e.g.,* CCA 201511021.
5. Rev. Rul. 2002-90, 2002-2 C.B. 985.
6. *Id.*
7. Rev. Rul. 77-316, 1977-2 C.B. 53.
8. 881 F.2d 247 (6th Cir. 1989).
9. *See* Rev. Rul. 2001-31, 2001-26 I.R.B. 1348.
10. *See* Rev. Rul. 2002-90, 2002-2 C.B. 985.
11. Through the cooperation of these unrelated groups, both risk-shifting and distribution are more easily met. *See* Rev. Rul. 78-338.

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