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Doctrinal Tools the IRS Will Use to Challenge Claimed Tax Benefits of 'Micro' Captive Insurance Companies

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Every tax season, the IRS 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. Their inclusion 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. Although its scrutiny is directed to several apparent abuses of captives, the IRS is particularly sensitive to taxpayers using them to evade estate and gift taxes. The trouble for the industry is predicting where and how the IRS will distinguish micro captives formed for “abusive” purposes from those with legitimate design, especially given that most of these transactions are designed to comply with the literal letter of the law. Because of their strict compliance, the IRS’ attack of these captives cannot hinge on alleged technical violations. Instead, the agency will turn to several related common law doctrines. Collectively, these doctrines stand for the general proposition that technical compliance with the Tax Code — without substantive compliance — is no compliance at all. Thus, even where a taxpayer ostensibly observes all nuances of a particular law, if a transaction’s purpose is merely to fabricate the circumstances or create the pretenses necessary to achieve a certain tax goal, courts could resort to this body of law to impede those tax benefits. Under the umbrella of anti-avoidance law are at least five doctrines: substance over form, sham transaction, business purpose, economic substance and step transaction. Though the semantics may differ, there is a good deal of overlap between them, and it is not unusual for a court to deny tax benefits on multiple bases. **The**

'Substance Over Form' Doctrine

The substance-over-form d The government might resort to the substance-over-form doctrine if it suspects that a taxpayer entered into a transaction to achieve ends other than those proffered by the taxpayer as its primary motivation. Take, for example, a taxpayer who “sells” an asset with a built-in capital loss to a related party and then leases it back. The IRS’ view of such a transaction might be that although the taxpayer formally transferred title, in substance he transferred nothing and made it appear otherwise only to take a deduction. In that case, the IRS would deny the capital loss deduction. **The Business-Purpose Doctrine**

This doctrine distinguishes transactions with a valid business purpose from those primarily designed to avoid tax. Although it allows a taxpayer with a primary motive other than tax to use the most tax-efficient means, courts will not give effect to transactions that lack a *primary* business purpose other than tax avoidance. If it suspects that tax is the primary motive, the government will argue that the taxpayer had no independent business purpose for the transaction and that the reported tax benefits should be disallowed. Most transactions have tangential consequences, so it is not enough simply to point to favorable tax consequences and assume that they were the primary motive. Thus, the fundamental controversy will be whether those consequences were the taxpayer’s central objective or merely incidental. If the transaction’s tax motivation outweighs the business motivation, a court may deny the intended tax benefits. For example, a taxpayer who forms a captive might represent that its primary purpose was to secure otherwise unavailable coverage. The IRS, after investigation, might conclude that the taxpayer’s primary motive had nothing to do with insurance but instead was to find a way to convey assets without triggering transfer taxes. A more obvious example is a transaction designed to generate capital losses. A rational person would never enter into an investment transaction that is guaranteed to lose money. But if the transaction would allow the individual to avoid tax on sizeable capital gains, the “investment” suddenly appears more rational. Where the government can prove that generating the tax loss was a taxpayer’s primary motivation for engaging in the transaction, the deduction can be disallowed. **The Sham-Transaction Doctrine**

The sham transaction doctrine analyzes the taxpayer’s purported activities and determines whether they are a sham or bona fide. If a taxpayer only outwardly appears to engage in a transaction but has otherwise taken measures to ensure that it will have no substantive effect, the transaction is said to be a “sham.” In such circumstances, the IRS will deny any tax benefits that would ordinarily flow from the activity. Two types of “sham transactions” exist: “shams in fact” and “shams in substance.”[1] Shams-in-fact are mere paper transactions in which the economic activity that generates a particular tax benefit never actually occurs. A sham-in-substance, by comparison, is a transaction that occurs but lacks economic substance beyond the generation of tax benefits. The first type is objective, while the second has a subjective component and is thus harder to identify and prove. An example of a sham-in-substance is when a captive insures a risk pool and an unrelated party indemnifies the captive. The captive’s assumption of risk is a “sham” because any claims loss will be offset by the guaranty. Courts have developed a two-part test to sniff out shams-in-substance. A

sham transaction exists if:

- The transaction is not motivated by a business purpose other than tax considerations (business-purpose test).
- The transaction is without economic substance because there is no real profit potential in it (economic-substance test).[2]

Some courts have held that the business-purpose and economic-substance tests are separate doctrines and that the transaction is a sham if either applies.[3] **The Economic-Substance Doctrine**
This doctrine voids transactions that seek to yield tax benefits without requiring a change in the taxpayer's economic position independent of those benefits. The tax shelter cases of the 1990s and early 2000s demonstrate how the government used the economic-substance doctrine to disallow tax avoidance strategies that, while complying with the literal letter of the law, lacked independent economic substance. At common law, the doctrine typically requires two different inquiries: an objective inquiry into the realistic profit potential of the transaction, and a subjective inquiry into the taxpayer's nontax business purpose in engaging in the transaction. In this way the doctrine borrows from the business-purpose and sham-transaction doctrines.[4] Because courts have at times required taxpayers to show both profit potential and business purpose,[5] while at other times only one of the two,[6] it is difficult to predict how the doctrine will be applied in specific cases. **The Step-Transaction Doctrine**
The final anti-avoidance doctrine, the step-transaction doctrine, operates to collapse a series of connected transactions into a single one. Under this doctrine, even bona fide individual transactions may be disregarded and treated as a single composite transaction.[7] As the Supreme Court has explained: "[I]nterrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus 'linking together all interdependent steps with legal or business significance, rather than taking them in isolation,' federal tax liability may be based 'on a realistic view of the entire transaction.'"[8] In other words, if the taxpayer has taken additional steps to achieve certain ends only to reduce its tax burden where a more direct path to those ends would have resulted in a greater tax burden, courts may choose to impose the greater tax. This doctrine, of course, is at tension with a taxpayer's freedom to structure transactions with a primary independent business purpose in a tax-efficient manner. Courts typically employ one or more of the following three tests to determine whether or not to invoke this doctrine. Tax benefits can be thwarted if any one of them is satisfied[9]:

- The "binding commitment" test, the most rigorous test of the three, considers whether there is a binding commitment at the time of a transaction to undertake a temporally subsequent step. If there is, the court may collapse the steps and view them as integrated stages of the same transaction. Because it is the most rigorous of the three, this test typically is applied only when a great deal of time has passed between the steps.

- The “end result” test examines whether separate steps have been prearranged as parts of a single transaction to achieve a particular result. This test is most often invoked in connection with the step-transaction doctrine.
- The “mutual interdependence” test asks whether separate steps are so interdependent that one would be legally useless without the others. Said another way, this test is concerned with the objective relationship between transactions and not with the “end result.” Commonly, this test and the end-result test supplement one another.

Captive Insurance and Anti-Avoidance Law

What can one take away from all of this? In the captive context, the IRS generally will investigate to determine whether a closely held business formed a micro captive primarily because it wanted the insurance benefits. If so, the taxpayer is entitled to the fringe tax benefits that come along with forming and operating a captive, as permitted in the Tax Code. But a taxpayer who, for example, forms a captive despite having no unmet insurance needs will be subject to closer IRS scrutiny to determine if it formed the captive purely for tax purposes. Those who use micro captives should scrutinize their own transactions using these principles and put themselves in the shoes of an objective observer to help predict whether the structure would survive audit. But even where the IRS is unpersuaded, these doctrines are pliable and reasonable people can reach different conclusions — meaning that it may well be worth challenging a negative IRS finding in the courts. This is especially true as the IRS continues to challenge boundaries in its campaign against micro captives. ___ **Notes**

[1]*See* Beckett G. Cantley, *Relearning the Lesson: IRS Judicial Doctrine Attacks on the Captive Insurance Company Pre-Planned Tax Deductible Life Insurance Tax Shelter*, 14 Hous. Bus. & Tax L.J. 179, 189-90 (2014).

[2] *Rice’s Toyota World Inc. v. Comm’r of Internal Revenue*, 752 F.2d 89, 91 (4th Cir. 1985).

[3] *Kirchman v. Comm’r of Internal Revenue*, 862 F.2d 1486, 1492-1493 (11th Cir. 1989).

[4] *ACM P’ship v. Comm’r of Internal Revenue*, 157 F.3d 231, 247 (3d Cir. 1998); *Winn-Dixie Stores Inc. v. Comm’r of Internal Revenue*, 254 F.3d 1313, 1316 (11th Cir. 2001).

[5] *See, e.g., Rice’s Toyota World*, 752 F.2d at 91.

[6] *See, e.g., United Parcel Serv. of Am. v. Comm’r of Internal Revenue*, 254 F.3d 1014, 1018 & n.2 (11th Cir. 2001) (disagreeing with *Rice’s Toyota World* and endorsing disjunctive test for economic substance that disregards transaction “when it has no economic effects other than the creation of tax benefits,” or when “it has no business purpose and its motive is tax avoidance” (internal quotation marks omitted)); *James v. Comm’r of Internal Revenue*, 899 F.2d 905, 908–10 (10th Cir. 1990) (rejecting 4th Circuit’s conjunctive formulation and holding that “[t]he better approach, in our view, holds that ‘the consideration of business purpose and economic substance are simply more precise factors to consider in the [determination of] whether the transaction had any practical economic effects other than the creation of income tax losses.’” (second alteration in original) (quoting *Sochin v. Comm’r of Internal Revenue*, 843 F.2d 351, 354 (9th Cir. 1988))); *Sochin*, 843 F.2d at 354 (clarifying that disjunctive test that considers both subjective and objective factors, rather than “rigid two-step analysis,” is correct standard for economic substance doctrine), *rev’d on other grounds*, *Keane v. Comm’r of Internal Revenue*, 865 F.2d 1088 (9th Cir. 1989); *see also H.J. Heinz Co. & Subsidiaries v. United States*, 76 Fed. Cl. 570, 583–84 & n.26 (2007).

[7] *Comm’r of Internal Revenue v. Clark*, 489 U.S. 726, 738 (1989) (quoting Boris Bittker, Federal Taxation of Income, Estates and Gift s ¶ 4.3.5, 4–52 (1981)).

[8] *Id.*

[9] *Andantech LLC v. Comm’r of Internal Revenue*, 83 T.C.M. (CCH) 1476 (T.C. 2002), *aff’d in part and remanded*, 331 F.3d 972 (D.C. Cir. 2003 *Original*

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