CARLTON FIELDS

Standards the IRS Will Apply in its Campaign Against 'Micro' Captive Insurance Companies

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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 systematic threat to its enforcement of the tax laws. The Dirty Dozen list typically is not where the IRS describes the sorts of sophisticated tax shelters included among its “listed transactions” or “transactions of interest.” This year’s list, for example, includes the likes of telephone cons. But also on the list is 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 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 captives to avoid 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. In this high-scrutiny environment, it is more important than ever for planners to understand the guidelines the IRS will apply in establishing that line and appreciate how those standards might evolve over the short term. They should also understand, though, that even if a particular arrangement satisfies these standards, the IRS still might endeavor to disallow the tax benefits if it concludes that tax was the primary motivation or that the captive provides “insurance” merely in form and not in substance. **'Insurance' for Tax Purposes**

Although micro captives are unique vis-à-vis their larger cousins formed by corporate conglomerates, the IRS applies the same rules to both. The central question the IRS will endeavor to answer for all captives, regardless of size, is whether it provides actual “insurance.” If it does, then the IRS generally will honor the consequent tax benefits. But if it concludes that no real “insurance”

exists, the IRS will disqualify the captive and assess tax liabilities against it, the insured and possibly individuals who own related business entities. As will be seen below, it is significantly easier for larger captives to satisfy these standards. As a result the IRS' one-size-fits-all approach has a regressive and disproportionate impact on micro captives. The Tax Code does not define "insurance." The governing analysis, therefore, traces its origins to the U.S. Supreme Court's decision in *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941). "Historically and commonly insurance involves [both] risk-shifting and risk-distributing," the court said. "That these elements of risk-shifting and risk-distributing are essential to a[n] ... insurance contract is agreed by courts and commentators." Although modern-day standards have evolved and added additional nuance, risk-shifting and risk distribution remain the primary hurdles to persuading the IRS that actual insurance is present. Risk-shifting focuses on 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." Rev. Rul. 2002-90. Risk distribution, on the other hand, focuses on the insurer. The rule says it "allows 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 rule says, "the insurer smoothes out losses to match more closely its receipt of premiums." For decades, the IRS took the position that risk-shifting and risk-distribution could not occur within the same economic "family." The simplest example is a single corporate parent with a captive as its sole subsidiary. According to the theory, neither risk-shifting nor risk-distribution takes place where that parent purchases insurance from its captive. Because the parent is the full beneficial owner of the captive, it would suffer an offsetting financial loss if the captive ever paid a claim. Thus, the parent never really "shifts" the risk because it will continue to bear the economic burden in the event of a loss. The economic-family theory also held that risk distribution lacks in that context, since the captive would have assumed risks solely from its parent. The theory was conceptually defective in that it ignored the legitimate, primary motivation taxpayers had in forming captives in the first place — to insure risks of the captive's affiliates. In this way, the IRS punished captives for doing precisely what they were designed to do. Though the economic-family theory became antiquated in the face of more sophisticated captive arrangements, the IRS was slow to abandon its position. For some time, it continued to apply the theory to disqualify insurance transactions between brother-sister business entities. But despite, or perhaps because of, its dogmatic adherence to the economic-family theory, the IRS suffered a series of losses in the courts. Seminal precedent condoning brother-sister insurance developed in the 1980s, but not until the new millennium did the IRS formally abandon the economic family theory. This watershed moment reflected that, although easy for the IRS to apply, the cookie-cutter nature of the economic-family theory did not account for the nuances that separated different captive structures. But the IRS' shift also created a guidance vacuum. To satiate taxpayers' understandable yearning for predictability, the agency created a series of safe harbors that, if met, would allow captive transactions within the same economic family to qualify as "insurance." Two separate revenue rulings created the most important safe harbors, each of which represent a different path to achieving risk-shifting and-distribution. Revenue Ruling 2002-90

addressed insurance transactions between subsidiaries of a common parent. The case involved a domestic holding company that owned all of the stock of its 12 domestic subsidiaries, each of which had “a significant volume of homogeneous risks.” The holding company formed an adequately capitalized, licensed insurance subsidiary to insure directly the professional liability risks of each of the 12 subsidiaries, none of which amounted to more than 15 percent or less than 5 percent of the captive’s overall assumed risk. The IRS held that, on those specific facts, there was sufficient risk-shifting and distribution. Although the bright-line takeaways from Revenue Ruling 2002-90 were the number of subsidiaries and the proportion of risk ceded by each, the IRS equally emphasized that “[i]n all respects, the parties conduct[ed] themselves in a manner consistent with the standards applicable to an insurance arrangement between two unrelated parties.” The IRS noted with approval that there were no financial guarantees between the entities, the captive charged arm’s-length premiums, the captive was fully licensed, the captive faced actual hazard and the parent formed the captive for “a valid non-tax business purpose.” Thus, while the safe harbor undoubtedly required 12 entities, just as vital to the ruling was that the captive pooled the premiums “such that a loss by one operating subsidiary is borne, in substantial part, by the premiums paid by others.” In other words, it not only looked like insurance but operated like it as well. Around the same time, Revenue Ruling 2002-89 set the standard for those circumstances where parent-subsidiary arrangements can qualify as insurance. The IRS considered two similar though vitally distinct sets of facts. In both scenarios, a domestic corporation formed a wholly owned subsidiary to insure the parent’s professional liability risks, either directly or as a reinsurer. In the first scenario, the premiums derived from the parent constituted 90 percent of the total premiums earned in a year. In turn, the captive insured 90 percent of the corporation’s total risks. The IRS held that this arrangement did not constitute insurance because it lacked adequate risk-shifting and distribution. As a result, the agency concluded that the premiums were not deductible. In the second scenario, however, the captive derived less than 50 percent of its annual premiums from its parent. Likewise, the liability coverage the subsidiary provided the corporation was less than 50 percent of the risks assumed by the captive. The IRS held that there was adequate risk shifting and distribution and that the premiums could therefore be deducted. Although the safe harbors brought with them some much-needed predictability, recent legal developments suggest that they too may take an overly simplistic view of captive insurance within the same economic family. Specifically, taxpayers recently secured two key tax court victories in *Securitas Holdings Inc. v. Commissioner*, T.C. Memo 2014-225 (T.C. 2014), and *Rent-A-Center Inc. v. Commissioner,* 142 T.C. 1 (T.C. 2014). Though *Rent-A-Center* had a particularly vigorous dissent, most commentators agree that both sets of facts demonstrated sufficient risk-shifting and distribution. What is most notable about these cases, however, is that the courts deemphasized the “number of insureds” as a determinative factor, thus distancing themselves from Revenue Ruling 2002-90. It is too soon to know whether these holdings will cause the IRS to relax further its application of the risk-shifting and distribution requirements. But unless and until it does, one must assume that it will continue to apply its own standards. Should a borderline dispute reach the courts, however, *Securitas Holdings* and *Rent-A-Center* are beneficial to taxpayers. **An Environment of Uncertainty**

While it is comforting when a captive objectively qualifies for one of the IRS' safe harbors, that is not always possible, especially for small captives. After all, not many small businesses have 12 subsidiaries. It is also important to keep in mind that the safe harbors are merely examples of circumstances where the IRS agrees there is sufficient risk-shifting and distribution. As both *Securitas* and *Rent-A-Center* demonstrate, there are other ways to make that showing. Rather than hard-and-fast rules, a totality of the circumstances analysis governs. To avoid unwanted IRS attention, a planner should analyze a proposed structure and objectively s whether insurance rather than tax is the true motivation for forming the captive. If that is the case — and assuming compliance with all other rules — the odds significantly increase that the captive will pass IRS muster. Such loosely defined standards are no one's preference, but a good dose of common sense can go a long way toward planning a captive that withstands IRS pressure. But should the IRS come knocking, it is critical to retain quality tax controversy counsel immediately. Additional developments are sure to follow as the IRS continues to test how far courts are willing to go along with its effort to curb perceived abuse. While *Securitas* and *Rent-A-Center* were IRS defeats, they also both involved captives of large companies rather than the sort of closely held businesses likely to own micro captives. In other words, the IRS can easily distinguish those cases from most, if not all, micro-captive arrangements. It is thus hard to predict how courts will apply this new precedent once some of the IRS' assessments make their way out of the agency and into the court system. This area of the law remains in flux and subject to further change not only in the courts, but also in Congress.

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