

The Prospect for a Legislative Fix in the Case of Certain Promoters Using Micro Captives Deemed Abusive by the IRS

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Despite a considerable reduction in budget and personnel, the Internal Revenue Service announced earlier this year that it would devote considerable time and effort to crack down on what it views as widespread abusive applications of so-called micro captives. Micro captives are insurers that elect under Section 831(b) of the Tax Code to be taxed on their investment rather than premium income. Such entities are “micro” because the Section 831(b) election is available only to captives with no more than \$1.2 million in annual net written premium. Focusing on these captives allows the IRS to efficiently employ its dwindling resources because a single audit of a suspected promoter can spawn deficiencies against multiple captives and related persons. Such efficiency is possible because the transactional structure used by a single promoter supplies the IRS with a blueprint that it can use against others linked to that promoter. This commentary describes arrangements that the IRS would likely deem “abusive” and considers the potential for a legislative response. **PROMOTED SCHEMES AND ABUSES**

To qualify as bona fide insurance, a captive of a small business must achieve both risk-shifting and distribution. To make that showing, the captive must insure sufficiently diverse, unrelated risk. The IRS has held that where a captive insures risks from at least 12 related entities, none of which is less than five or more than 15 percent of the captive’s overall assumed risk, risk-shifting and distribution likely exists. But because they typically are owned by smaller business entities, micro captives rarely have 12 affiliates to insure, leaving them with little choice but to assume true third-party risk. Doing so is not simple, especially for a small insurance company that aims to keep its annual premiums below \$1.2 million. Therefore, many captives have turned to outside managers to operate the company and secure third-party risk adequate to meet the IRS’s exacting standards. The IRS is concerned that promoters of “abusive” uses of captives — that is, promoters seeking to avoid tax rather than secure insurance — are lurking among reputable managers. Because many promoters structure their products to give the appearance of technical compliance with the letter of the law,

the IRS will rely on what is known as “anti-avoidance law” to challenge the claimed tax benefits. Generally speaking, the judicial doctrines that comprise anti-avoidance law hold that technical without substantive compliance with the Tax Code is no compliance at all. Thus, even where a taxpayer apparently abides by the dictates of a particular tax provision, this jurisprudence allows courts to disallow the claimed tax consequences if the transaction observes the tax laws in letter but not spirit. Congress recently codified the “economic substance” iteration of this body of law.[1] What follows are examples of red flags and arrangements that may technically comply with the Tax Code, regulations, and guidance, but that the IRS might nonetheless challenge as primarily motivated by taxes. ***'Off-label' uses***

While off-label uses may produce incidental benefits, a taxpayer must be prepared to show that a captive’s primary purpose is insurance. For example, the IRS believes that many taxpayers are using micro captives to avoid gift and estate taxes. Taxpayers achieve this goal by transferring “premiums” to the captive without taxation and placing the beneficial ownership of the captive in a family partnership. Another off-label use has the captive purchase a life insurance policy on the parent’s owner, effectively allowing the owner to deduct otherwise non-deductible life insurance premiums. When considering these and other similar off-label uses, the IRS might argue that the primary purpose of the captive is to reap tax benefits with insurance motives of secondary or even no importance. Such a showing would help the government succeed under common anti-avoidance law standards. ***Substantive risk-shifting***

Many promoters use risk pools to create third-party risk for client captives to insure. Sometimes, however, such risk pools provide only the appearance of risk-shifting and distribution. For example, policies issued by captives may have excessively high deductibles that make it unlikely that claims will ever trigger coverage for the pool’s claims. In other cases, promoters might create supposed risk pools and — at least outwardly — 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. Another tactic involves the parent corporation purchasing a policy on the open market but then having the insurer cede the entire risk to the captive. Because the third-party carrier cedes most or all of the risk, the captive is simply insuring its parent, albeit indirectly. 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***

If a captive insurer is not a legitimate, independent insurance company and instead acts merely as a shell, the IRS might invalidate the captive. The policy papers should indicate the captive’s due diligence, and its reserves should be capitalized adequately. In the same vein, the captive should calculate a premium that is defensible under arm’s-length market conditions and should underwrite all its risks. A one-sided claims history or an insured’s failure to pay premiums with impunity will suggest inadequate independence. No one fact will be determinative, but the goal should be to create the impression that the parent treats the captive as an independent entity. ***'PIGGYBANK'***

CAPTIVES AND IMPLAUSIBLE RISKS

When auditing, the IRS will look for indicators that the captive is motivated more by tax rather than

insurance considerations. The IRS views “loan backs” as just such an indicator. A loan back occurs when a parent pays premiums to the captive, both sides take their deductions, and the captive loans the money back to the parent. The transaction concludes with the parent retaining the beneficial use of the money it paid as premiums and avoiding paying tax on those amounts. More subtle indicators include captives that invest much or all of their premium income in the parent, affiliates, or in other ways that benefit the parent. Finally, a captive with excessive reserves suggests to the IRS that the captive does not function as a true insurance entity. Those managing captives that are truly motivated by tax considerations would prefer that claims do not get in the way of capital preservation. Therefore, another warning sign is where the captive assumes only implausible risks, such as terrorism loss in the rural Midwest — particularly where the premium does not reflect the risk’s unlikelihood. Many use such implausible risks to make a captive arrangement appear motivated by insurance when in fact tax savings are the real prize. When the IRS discovers such scenarios, it will suspect that the primary motive of the captive is not insurance. ***Insurance risks***

Recently, an IRS 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.”[2] 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, careful planners must ensure that even if a captive arrangement complies with all other requirements, the insured risk is the kind deemed acceptable by the IRS. It is unclear exactly where the IRS will draw the line on this issue. **CONGRESSIONAL RESPONSE**

Partly because of an increase in tax marketing, micro captives have grown in popularity in recent years. The IRS has historically challenged various sorts of captive arrangements, but a recent confluence of several factors has caused the agency to intensify its scrutiny of what it considers to be abusive use of micro captive insurance companies. In 2013, Republican Sen. Chuck Grassley of Iowa introduced a bill that would raise the net written premium cap under Section 831(b) election from \$1.2 million to \$2.2 million. Grassley, who sits on the Senate Finance Committee, explained that small farmers and other rural residents require the larger cap to make up for the dearth of available insurance products for their unique risks. The IRS likely took note that, should the bill pass, Congress would nearly double the amount micro captives can deduct — making them all the more attractive. Grassley echoed the IRS’s concern at a committee hearing in February. He noted that many captive insurers are “taking advantage of the special treatment for small mutuals for estate planning rather than legitimate business needs.”[3] Thus, while any new legislation might increase the net written premium a Section 831(b) captive can earn, Grassley’s comments make it clear that legislative amendments aimed to combat the perceived abuse are on the table. Estate planning represents but one of the IRS’ concerns regarding micro captives, but the IRS agreed to prepare a report “on the abuses of captive insurance” for the committee’s consideration. *Original published in Westlaw*

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[1] See 26 U.S.C. § 7701(o).

[2] I.R.S., Chief Counsel Advisory, CCA 201511021 (Mar. 13, 2015).

[3] *Open Executive Session to Consider Various Original Tax Bills: Hearing Before the U.S. S. Comm. on*

Finance (Feb. 11, 2015) (statement of Sen. Charles Grassley), <http://www.finance.senate.gov/hearings/hearing/?id=5499ed9f-5056-a032-5212-6b9d23e05a31>

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