THE IRS HAS DECLARED WAR ON THE ABUSIVE USE OF MICRO CAPTIVE INSURERS

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Tax practitioners should understand the IRS's challenges to captive insurance companies and anticipate how to best defend any existing captive arrangements.

The IRS recently began to apply vigorous scrutiny to perceived abusive uses of "micro" captive insurance companies (captives). This article explains what defines a captive, why the IRS cares, the applicable tax laws, and the types of captive arrangements the IRS is targeting.

What is a captive insurer and why form one?

Captive insurance companies are formed as subsidiaries to insure the risks of, and affiliated with, their corporate parents. Their application spans from behemoth corporate conglomerates with hundreds of subsidiaries to small, independent farmers, doctors, and other closely-held businesses. Among other benefits, captives allow businesses to insure risks that otherwise would not or could not be insured. In the latter case, some businesses face perils for which commercial carriers do not offer coverage products. Without captives, these businesses would either have to forego coverage or self-insure. If the prospective insured believes the risk is significant enough to warrant coverage, foregoing coverage is unacceptable. Further, while self-insurance is better than foregoing risk mitigation altogether, such arrangements deprive the insured of valuable tax benefits.

Even when commercial insurance is available, the coverage may be prohibitively expensive, forcing the business to do without coverage. Insuring with a captive can be more affordable for those businesses, and because a captive's coverage is customizable, the insured has the added benefit of greater control over the coverage terms.

For example, the "duty to defend" in the industry standard general comprehensive liability policy allows the insurer to select and direct defense counsel. An insured who prefers to select its own counsel might not find such coverage available on the open market at reasonable rates. Under those circumstances, a captive would make a great deal of sense. Captives are customizable in other ways as well. There are a plethora of jurisdictions in which one may form a captive, and the regulatory environment can vary widely. Some foreign jurisdictions might offer lower reserve requirements and laxer investment restrictions. A small business contemplating a captive may be attracted to these options.[1]

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Additionally, by insuring with a captive, an insured pays its premiums as usual, but instead of those amounts going to enrich an unrelated party, they stay within the same corporate structure and, in that regard, the insured gets the best of both worlds. Captives also allow their owners to access the reinsurance market. Finally, and most relevant, there are tax benefits to using captives, including deductions of premiums paid by the insured and of unearned premiums received by the captive. Section 831(b) allows "micro" captives—those with no more than $1.2 million in annual net written premiums—to elect to pay tax on their annual investment returns rather than on their premium income. It is this deduction in particular that has led to much of the perceived abuse.

Circumstances leading to a surge in IRS scrutiny

There has been an increase in micro captives in recent years. While the IRS has a storied history of challenging all sorts of captive arrangements, a current confluence of several factors set the stage for the IRS to increase its scrutiny of what it views as the abusive use of micro captive insurance companies. In 2013, Senator Grassley of the Finance Committee introduced a bill to raise the net written premium cap under the Section 831(b) election from $1.2 million to $2.2 million. The bill similarly provides for future inflation adjustments. Senator Grassley explained that small farmers and other rural residents needed the larger cap to make up for the scarcity of insurance products available for their unique risks. The IRS took note that Congress might nearly double the amount that micro-captives can deduct.

At a Committee hearing in February 2015, however, Senator Grassley echoed the IRS's concern that many captive insurers are "taking advantage of the special treatment for small mutuals for estate planning rather than legitimate business needs."[2] Precisely how those transactions work is described below, but Senator Grassley opened the door for new legislation to curb that perceived abuse. Although estate planning reflects but one of the Service's concerns regarding micro captives, it has agreed to prepare a report "on the abuses of captive insurance" for the Committee's consideration.

Around the same time as Grassley's remarks, the IRS released the 2015 version of its annual "dirty dozen" list. This is not a venerable group. This year's iteration lists abusive captive schemes alongside the likes of telephone cons and identity theft. Through inclusion on this list, the IRS is signaling a renewed commitment to investigate and challenge questionable captive arrangements. However, even before it released the dirty dozen list, the IRS had several "promoter" audits in progress. The IRS uses these audits to investigate persons suspected of marketing abusive tax schemes.

Currently in the midst of a well-publicized downsizing, the IRS likely views promoter audits as a particularly effective use of its diminishing resources. As part of a promoter audit, the IRS will thoroughly investigate its target and gain intimate familiarity with the sorts of transactions marketed as well as the notable attributes and methods used by certain promoters. At some point during the audit, the IRS will demand a client list, and often the promoter will provide that information either because it is legally compelled to or simply to leverage its own negotiating position. Once it has that list, the IRS can launch audits of not only the captives linked to those promoters, but also of the entities and individuals affiliated with those captives. Also, because by that point it is already familiar with that promoter's brand of transaction, the IRS has a blueprint for the subsequent audits. Thus, micro captives offer the IRS an opportunity to ride the coattails of its own promoter audits at a time when its budget and personnel have been slashed.

Together these circumstances provide the IRS with every incentive to increase the intensity and number of audits related to micro captives. Tax planners, therefore, should understand the bases of the IRS's challenges not only to avoid these pitfalls when forming new captives, but also to anticipate how one might defend an existing captive arrangement should the IRS come knocking.

What qualifies as "insurance" for tax purposes?

The following elements are used to determine whether a captive insurance company arrangement is providing insurance for tax purposes.

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[1] Note, however, that locating a captive in a foreign jurisdiction will trigger a host of consequential legal issues to consider.

[2] Grassley, Open Executive Session to Consider Various Original Tax Bills, U.S. Senate Committee on Finance (2/11/15), www.finance.senate.gov/hearings/hearing/?id=5499ed9f-5056-a032-5212-6b9d23e05a31.

Risking-shifting and distribution (and beyond). An insured's premiums for most types of insurance are deductible as ordinary business expenses under Section 162 and its accompanying regulations.[3] As noted above, if the captive qualifies for and makes the Section 831(b) election, its premiums are not taxed as income. However, to qualify for these tax benefits, the IRS must agree that a captive arrangement provides actual "insurance," which is not defined by the Code. In *Helvering v. Le Gierse*,[4] however, the 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."

Risk-shifting and distribution, therefore, have dominated much of the analysis in the decades since *Le Gierse*, though additional factors have gained importance. Most of these factors go toward a general "facts and circumstances" analysis of whether the captive is a bona fide, independent insurer. The IRS will consider, 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 timely; and whether the captive uses quality insurance policies and formation papers.[5] Other precedent holds that, to qualify as "insurance," the contemplated hazard must be an "insurance" risk rather than some other peril that is not typically insured, such as investment risk.[6] Thus, the IRS has several ways that it can attack a given captive arrangement. Risk-shifting and distribution are still the primary hurdles, and satisfying both significantly increases the odds that a particular captive will survive scrutiny.

Risk-shifting analysis focuses on the insured, particularly whether it "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."[7] Risk distribution, on the other hand, focuses on the insurer and "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 insurer smoothes out losses to match more closely its receipt of premiums."[8] The easiest way for a captive to demonstrate risk-shifting and distribution is to write coverage solely for diverse, third-party risks. In this way, however, the IRS's definition of insurance conflicts with the practical purpose for forming a captive—to insure risks affiliated with its corporate parent. It is with this inherent tension that the IRS and courts have continually had to grapple.

Risks of the same "economic family." The *Le Gierse* test led the IRS to develop the now-defunct "economic family theory." In the prototypical example, if a parent forms a subsidiary captive and purchases coverage from it, no risk transfer takes place because the risk remains within the "economic family" of business affiliates. Because the parent owns 100% of the subsidiary, the captive's claim payment merely shifts the money from one pocket of the parent to the other. The parent is essentially paying for its own loss, and no risk transfer will have taken place.[9] Although no longer under the guise of the economic family theory, it remains true today that a captive with risks 100% attributable to its parent would fail the *Le Gierse* test. A similar, though more nuanced, example is the purported transfer of risk between brother-sister entities, both owned by the same parent corporation. Because brother-sister entities typically do not own equitable interests in one another, 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. There is a dizzying volume of cases with variations of these themes, and it has led to inconsistent outcomes regarding what qualifies as insurance.

Modern safe harbors. The seminal case that held that brother-sister arrangements can qualify as insurance is *Humana, Inc.*[10] The Sixth Circuit found that there was risk-shifting where the insured affiliate owned no stock in (and thus would suffer no negative financial effect in the event of an honored claim by) the captive. Though *Humana* came down in 1989, not until 2001 did the IRS officially abandon the economic family theory and acknowledge that

[3] Reg. 1.162-14(a).
[4] 312 U.S. 531, 25 AFTR 1181 (1941).
[5] See, e.g., Rev. Rul. 2002-91, 2002-2 CB 991.
[6] See, e.g., CCA 201511021.
[7] Rev. Rul. 2002-90, 2002-2 CB 985.
[8] *Id.*
[9] Rev. Rul. 77-316, 1977-2 CB 53.
[10] 881 F.2d 247, 64 AFTR2d 89-5142 (CA-6, 1989).
[11] See Rev. Rul. 2001-31, 2001-26 IRB 1348.

brother-sister arrangements can qualify as insurance.[11] Shortly thereafter, the IRS issued a series of Revenue Rulings that created some much-welcomed safe harbors.

In Rev. Rul. 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. Each of the 12 affiliates accounted for no more than 15% and no less than 5% of the captive's overall exposure, which the IRS ruled allowed adequate distribution of risk. The IRS's abandonment of the economic family theory also allowed it to treat as "insurance," under certain circumstances, a captive's assumption of its parent's risk. In Rev. Rul. 2002-89,[12] 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 when 90% of a captive's total risk stemmed from its parent, such arrangement was not "insurance."

According to the IRS, it was notable that in both Revenue Rulings there was a lack of other factors that might nullify the substantive transfer of risk, such as indemnity, guarantee, or hold harmless agreements. There also were no facts suggesting that any of the captives lacked independence or were otherwise shams. Though the IRS's rulings were limited to the precise facts at issue, they offer valuable bright line rules for planners.

Reconciling governing standards with micro captives

One must ask if the IRS's standards for testing whether a particular arrangement qualifies as "insurance" can be reconciled with the very existence of micro captives. It is one thing for the IRS to require the captive of a Fortune 500 company to act like a large, sophisticated, and independent insurance company, with hired actuaries, underwriters, adjusters, etc. These arrangements are supported by the deep pockets of the entities sponsoring and forming the captives. Also, such captives write so much coverage and receive so many premiums that they can afford to navigate the regulatory morass of writing insurance coverage diverse enough to meet the IRS's standards. Moreover, the associated conglomerates are often large and diverse enough that the captives can show risk-shifting and distribution without having to write a single, unaffiliated policy.

What about micro captives? The Code caps the Section 831(b) election to insurers at $1.2 million in annual premiums. By having the Section 831(b) election, the Code not only condones the existence of micro captives, but proactively incentivizes them. It is without question, however, that compliance with the IRS's exacting standards has a regressive effect on micro captives. Most micro captives have parents that are closely-held, small businesses, which usually have limited resources and narrow expertise.

Consider Senator Grassley's small farmer example. While the farmer undoubtedly has agricultural expertise, odds are he or she has only superficial familiarity with the insurance industry. Even assuming that the farmer is not dissuaded by the regulatory trappings of forming and operating an insurance company (and that he or she is able to do so without unwittingly attracting unwanted IRS attention), how is that farmer going to show risk-shifting and distribution? Generally, closely-held businesses do not have 12 subsidiaries, meaning that if the farmer wants to enjoy the predictability created by the IRS's safe harbors, the newly-minted captive would have to assume unrelated risk. However, it is not as simple as setting up shop and marketing insurance products to the public; these activities are subject to even stricter regulation. If the farmer wants to take advantage of the Section 831(b) election, he or she must write that coverage with the $1.2 million annual premium cap in mind. At that point, is it even worth it?

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Generating risk-shifting and distribution through captive managers

It is little wonder that these daunting implications dissuade many closely-held businesses from forming captives. However, the practical appeal of captive insurers remains strong, and consequently, there is a demand by small businesses for assistance with successfully forming and operating captive insurers. To meet this demand, there is a market of captive managers and "turn-key" operations. Though distinct, both types of services are attractive to closely-held businesses, as they allow those businesses to delegate both the creation of their captives and compliance with the IRS's and the host jurisdiction's regulatory framework. Many providers often have an intimate familiarity with issues such as where best to form the captive.

Captive managers, as the name implies, will actively manage the captive on behalf of the parent, in exchange for a periodic service fee. This way the closely-held business need not hire a full-time staff or otherwise delve into the minutiae of operating an insurance company. Because of economies of scale, capable managers can perform these tasks efficiently and reliably. A group of closely-held companies may also coordinate the hiring of a single manager to operate a "group captive," which insures and is owned by that unaffiliated group of small businesses.[13] "Turn-key" services are similar to and can overlap with managers, but such providers essentially offer "off-the-shelf" captives for purchase. Again the appeal is ease, and in this regard, the "turn-key" options are analogous to a low net worth individual using an affordable, boilerplate will.

In addition to supervising the captive's day-to-day, managers tout their ability to satisfy the risk-shifting and distribution requirements. This is an area in which the closely-held business must apply rigorous scrutiny to ensure the manager's methods will pass IRS muster. A common tactic is to have the insured purchase some of its coverage from a larger "pool" of risks operated by the manager. In exchange for a separate premium, the captive will reinsure the pool for a risk commensurate with the policy purchased by the parent insured. The manager will then treat that as third-party risk, and as long as that risk accounts for 50% or more of the captive's overall exposure, the parent is theoretically free to insure its remaining risks directly with its captive. Alternatively, the manager might coordinate 12 or more unrelated captives to reinsure one another. In either case, the reinsurance structure provides at least the appearance of third-party risk. The ultimate goal of any of these or similar arrangements is to place the captive squarely within one of the IRS's safe harbors. Because managers have access to many captives, it is easier for them to achieve these goals than it is for a closely-held entity that is new to the insurance industry and has access to only a single captive.

Promoted schemes and abuses

Although the IRS's rules arguably pushed small businesses into the waiting arms of captive managers, the creation of that market also led to the entry of "promoters" of abusive tax shelters involving captives. These promoters often masquerade as reputable managers. Promoters can make it difficult to identify where to draw the line between permissible and abusive structures. Some well-intentioned taxpayers (and managers for that matter) will find themselves lumped together by the IRS with those of lesser scruples. However, one reliable way to identify a promoter is by analyzing its marketing materials. If those materials advertise primary uses of captives that are unrelated to insurance, it is best to keep shopping.

One such use is estate planning. High net-worth individuals face the specter of significant estate and gift taxes, and many eagerly welcome tax efficient ways to transfer their assets to their loved ones. Setting up a captive and placing its equitable ownership interests in a trust operated for the benefit of one's beneficiaries will effectively allow a taxpayer to gift up to $1.2 million a year. Not only will this transfer avoid the gift tax, but the taxpayer will also get a tax deduction for making that gift under the guise of an ordinary and necessary insurance premium. If pure estate planning rather than contemporaneous gifting is the goal, the taxpayer can hold the shares of the captive while living and bequeath them to his or her heirs at death. Either way, when the IRS concludes that estate planning was the primary motive for forming the captive, it will likely disallow the deductions, recast the premiums as gifts, and tax them accordingly. This is just the sort of transaction the IRS is targeting.

Other taxpayers use captives as a means to deduct life insurance premiums, which are not among the types of insurance premiums deductible under Section 162. They achieve this by purchasing deductible property and casualty coverage from the captive. The captive then uses those premiums to purchase a life insurance policy on, for example, the life of the owner of the captive's parent. By placing the captive between the life insurer and the ultimate insured, taxpayers can deduct life insurance premiums in contravention of IRS regulations.

Some owners shift their income to captives simply to avoid the taxation of those amounts. So as not to expose those assets to significant risk of loss, the captives typically write policies

[12] 2002-2 CB 984.

[13] Through the cooperation of these unrelated groups, both risk-shifting and distribution are more easily met. See Rev. Rul. 78-338, 1978-2 CB 107.

[14] Section 953(d).

[15] CCA 201511021.

for implausible risks, and businesses pay "premiums" for that coverage, which the IRS would deem excessive given the remoteness of the ostensible hazard. Examples include hurricane insurance in Alaska or terrorism insurance in Wyoming. The businesses then deduct the premiums, and because it is nearly certain that the captives will never have to pay claims, the captives are essentially sophisticated piggybanks. Of course, U.S. insurance companies are usually subject to rigorous regulatory restrictions on the kinds of investments they are allowed to make. To avoid that, however, a business may form its captive in a foreign jurisdiction with more lenient investment and reserves rules. That way the business has more flexibility and greater options on how best to deploy the captive's assets.[14]

The IRS will rely on anti-avoidance law to disregard captive structure

A reasonable question is, if the "abusive" uses of captives technically comply with the dictates of the Code, on what grounds can the IRS mount a challenge? The answer lies in several related common law doctrines that hold that technical compliance with the Code without substantive compliance is no compliance at all. Thus, even when a taxpayer ostensibly observes the technical requirements of a particular law, if the transaction merely fabricates the circumstances necessary to achieve a certain tax goal, courts can resort to this body of law to thwart unintended tax benefits. There are at least five doctrines under the umbrella of anti-avoidance law: (1) substance over form; (2) sham transaction; (3) business purpose; (4) economic substance; and (5) step transaction. There is a good deal of overlap between them.

These doctrines have been incorrectly described as allowing a court to disregard a taxpayer's chosen means of achieving a certain ends if an alternative means would have resulted in greater tax. The analytical focus does not turn on the means used, but rather on the objective purpose of a particular transaction. Thus, when a taxpayer decides to enter into a transaction with a business purpose other than tax savings, he or she is free to explore and use the most tax efficient means. That is different, however, from a taxpayer who enters into a transaction primarily because of beneficial tax consequences. In that case, the government would argue that the taxpayer had no independent business purpose for the transaction and that the reported tax benefits should be disallowed. Extreme examples include transactions designed to generate capital losses. Intuitively, no rational person willingly enters into an "investment" transaction where the primary goal is to lose money. However, if avoiding tax on sizeable capital gains is the goal, suddenly intentional loss generation can seem rational. Moreover, sometimes the losses generated are only on paper and are not actual economic losses to the taxpayer. On that basis, the government might argue that the transaction lacked economic substance.

In another variation, the government might resort to the substance over form doctrine when a taxpayer contends that he or she entered into a transaction to achieve specific ends. Invariably in these contexts there are additional consequences of the transaction, but the taxpayer will argue that they are merely tangential. If the government can show that the taxpayer's true purpose was to achieve one of the tangential consequences, and if directly achieving that tangential benefit typically triggers a greater tax burden, the court may disregard the manner in which the taxpayer actually proceeded and tax him or her according to his or her deemed true purpose.

In the captive context, the IRS 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 Code. If, however, a taxpayer has no unmet insurance needs but still forms a captive, the IRS will take a closer look to determine whether tax motivations explain the decision to form the insurance company. The IRS will have an easier case to make if, for example, the taxpayer placed the stock in his or her grandchildren's name. In that case, the IRS will argue to disregard the insurance structure altogether and to tax the transaction as though the taxpayer made a direct gift, which the IRS would claim more accurately reflects the true economic substance of the transaction.

The IRS's audit strategy and targeted transactions

As noted above, managers often use risk pools to create third-party risk for micro captives. These pools are tempting targets for the IRS. If the IRS invalidates a pool through an audit, all of the cap-

tives relying on that pool for unrelated risk will tumble like dominoes. The first stage of the IRS's apparent strategy is to focus on perceived promoters and to identify follow-up targets simply by reviewing each promoter's client list. With those lists and a little effort, the IRS can cross-reference taxpayer identification numbers and select for audit the most promising targets. Such captives and individuals will be at a disadvantage, as the IRS will have had a head start through its examination of the promoter. Moreover, the IRS can play hardball with the threat of draconian penalties imposed for frivolous tax schemes. So, what will the IRS look for to determine whether a particular captive arrangement lacks economic substance?

"Off label" uses. Several "off label" uses are discussed above, but if the IRS concludes that the taxpayer's motive in forming and insuring with the captive was primarily for purposes unrelated to insurance, it will employ anti-avoidance law to unravel the transaction and tax it as it sees fit. While it is acceptable to consider some of these off label uses as fringe benefits, a taxpayer should be prepared to prove that its primary purpose was insurance. The ability to make that showing will vary depending on the facts. A business with risks for which most or all commercial insurers do not offer coverage will have an easier time convincing the IRS that the captive is bona fide than a company in a business sector with a rich history of commercially-available, competitive insurance products. Either way, the IRS's primary mission is to stamp out the use of micro captives for tax purposes, so this is the most important factor.

Substantive risk shifting. The IRS will flag arrangements that satisfy the risk-shifting requirement in form rather than substance. In the clearest example, a parent would purchase insurance from an unrelated commercial insurer that acts as a front, which then cedes the risk to the captive for the same premium paid by the parent, minus a fee. Other arrangements are more sophisticated and less obvious to spot. In the risk pool scenario, for example, a manager might require the parents to write letters of credit in favor of the pool or to otherwise indemnify or guarantee the pool for any claims they make. Managers do this to keep participation in the pool low-risk and high-reward. This tactic allows promoters to all but promise participants that they will not have to pay actual claims. Another common tactic includes having excessively high attachment points, which make it unlikely that claims will ever trigger the pool's liability. From an economic substance perspective, the common thread is that the parents retain rather than shift the risk of loss. For that reason, the IRS will almost certainly invalidate these structures.

Bona fide independence. If a taxpayer holds a captive out as a legitimate, independent insurance company, the captive should look and act the part. The IRS will investigate whether the captive is adequately capitalized and whether the formation papers, licenses, and the like are in strict compliance with the captive's situs rules. The quality of the written policies must be acceptable and written policies must actually be issued. All risks should undergo quality, independent underwriting, and premiums charged should have arm's-length fairness and reflect actual loss ratios. Also, there should be a demonstrable history of regular, timely payment of premiums. Claims history, though not necessary, is helpful; especially if the taxpayer can show that the captive adjusted those claims and considered the loss history in the underwriting of policy renewals. No one fact will be determinative, but the goal is for it to appear that the captive acts independently from its parent.

Implausible risks. Also referenced above, the IRS will apply common sense and ask whether the insured risk is reasonable. If the risk is unlikely ever to come to pass, the IRS will infer that the taxpayer had some motive other than insurance.

Piggybank. If it suspects that a taxpayer formed a captive primarily to receive and hold the parent's income, the IRS will look for certain warning signs. One example includes loan backs, in which 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. A less obvious indicator is captives that invest much or all of their premium income in the parent, affiliates, or in other locations that benefit the parent. Also, excessive reserves can signal to the IRS that the captive does not function like a truly independent insurance company.

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."[15] 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." Citing 1950 prece-

dent from the Second Circuit, 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 captive arrangement complies with all other requirements, careful tax planners must be sure that the insured risk is of the variety deemed acceptable by the IRS. There is a lack of clarity as to where exactly the IRS will draw this line.

Being proactive

It behooves anyone considering a captive to structure the arrangement in a way that avoids the minefields identified by the IRS. Of course, that is easier said than done when one is hoping to take advantage of the Section 831(b) election. One should analyze the structure with objectivity and a good dose of common sense. Is it clear that the transaction is primarily insurance motivated rather than tax motivated? Will the captive be set up to act truly independently? Does the captive qualify for any of the IRS's safe harbors for risk-shifting and distribution? If the answer to any of these questions is "no," there is a significant, and perhaps unacceptable, risk that the captive will not pass IRS muster.

For those captives already in existence that want to be proactive, a wise step is to hire an expert who is independent from any captive manager to analyze the structure. Should this review identify any weaknesses, the captive or parent can correct them going forward and limit their future exposure. Also, if the IRS selects a captive or parent for audit, it is critical that the affected parties hire quality tax controversy counsel immediately to devise an effective strategy with a long-term eye towards potential litigation.

Conclusion

Captive insurance companies can provide several benefits for companies that otherwise would be uninsured. However, when creating and managing a captive, tax practitioners should be aware of the challenges it may face from the IRS. ■