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CAPTIVE INSURANCE BEST PRACTICES AND THE DEFENSE OF IRS ATTACKS
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Oversight of implementation of the Affordable Care Act

Widely respected in Washington, D.C. and recognized throughout the tax community as a premier figure
alliantgroup Managing Director of Tax Controversy Services

Handled or supervised hundreds of state and federal tax examinations

Fifteen-year trial attorney with extensive experience representing clients in trials all over the country

Licensed in several state and federal jurisdictions, including tax courts, the U.S. Federal Court of Claims and the Fifth Circuit Court of Appeals.
THE alliantgroup ADVANTAGE

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Agenda

• Cover the basics of ensuring you qualify as an insurance company for federal tax purposes
• Discuss current IRS focus on 831(b) captives
• Cover the consequences of IRS adverse findings
• Areas to work on to improve outcome if the IRS arrives
What is a Captive Insurance Company (CIC)?

• An insurance company created to insure the risks of related operating businesses—often the parent and/or fellow subsidiaries

• Designate as “small” captive insurance company if qualified under IRC § 831(b)
  – Must meet several tests, among these:
    • A timely election
    • Limit on net premiums that can be received
    • Business purpose outside of tax
    • Provides insurance and meets definition of insurance company
    • The captive must look and act like a third party insurance company
Tax Benefits of Captive

• Under IRC § 162, insurance premium payments from operating business are deductible as ordinary and necessary business expenses.
• Under IRC § 831(b), premium payments received by a captive are NOT taxable, as long as yearly premiums do not exceed $1.2 million.
• Availability for foreign captive to be treated as United States taxpayer (e.g., non-CFC, FATCA).
U.S. Congressional Activity

- Senate Finance Committee passed a bill on 2/11 that raises the $1.2M cap on premiums
- Original bill narrowed definition of captive
  - Added new reporting requirements and restrictions on pools and reinsurance
- As passed by committee, removed restrictions because they were problematic for certain states
- Treasury Dept. asked to perform study on abuses of captive for estate planning purposes to support legislation, including the narrowed definition
- Work continues to see if agreement can be reached on congressional concerns
IRS Scrutiny

  - Captive Insurance
    - “Another abuse involving a legitimate tax structure involves certain small or “micro” captive insurance companies.”
    - “The promoters manage the entities’ captive insurance companies… assisting taxpayers unsophisticated in insurance to continue the charade.”
Promoter Audits under IRC § 6700

- IRS has commenced several promoter audits of captive managers/providers.
- IRC § 6700 imposes penalties for organizing and selling an abusive tax avoidance transaction if:
  - A promoter engages in an arrangement or plan under which it makes a false or fraudulent statement or gross valuation overstatement of the tax benefit to be provided that it knows or has reason to know is false with respect to a material matter.
- Penalty can be confiscatory.
The Current IRS Approach to Promoter Investigations

- Examiners request captive managers/providers’ customer lists and other information
- IRS has made contact and/or opened numerous audits of the clients of these captive managers/providers
The Current IRS Approach to Exams of 831(b) Captive Insurance Companies

- Audits and third party contacts are using similar IDR contents and, in large part, are coordinated.
- The relevant inquiries:
  - Is the product insurance?
  - Does the captive look and operate like an insurance company, including is there an arms-length relationship between the captive and the insured(s)?
Is the Product Insurance?

- IRC § 816(a) definition of “Insurance Company”:
  - “means any company with more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.”
- IRC does not define “insurance”
  - “Historically and commonly insurance involves risk shifting and risk-distributing.”
    - Helvering v. Le Gierse, 312 US 531 (US 1941)
  - The transaction must be insurance in its commonly accepted sense and the risk transferred must be an insurance risk.
Is the Product Insurance? Risk Shifting

• “From the insured’s perspective, insurance is protection from financial loss provided by the insurer upon payment of a premium, i.e., it is a risk transfer device.”

• Risk shifting requires transfer of the impact of a potential loss to the insured to a third party, which is generally accomplished by means of an insurance policy.
  – Clougherty Packing Co. v. Commissioner, 812 F.2d 1297 (9th Cir. 1987) aff’g 84 T.C. 948 (1985).

• For transfer of risk to occur, insurance coverage needs to actually insure loss that has some likelihood of occurring.
Is the Product Insurance?  
Risk Shifting

• The insurer must be well capitalized and financially capable of paying claims.

• Risk transfer is “reasonably self-evident” when: (i) potential loss under the agreement is much greater than the premium, (ii) the agreement contains standardized terms and conditions typical for the type of coverage, and (iii) the agreement does not include impermissible provisions regarding insurance.

Is the Product Insurance? Risk Distribution

- From the insurer’s perspective, insurance is a risk distribution device and relies upon the “law of large numbers.”

- “Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium because 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.”
  
  – Clougherty Packing Co. v. Commissioner, supra.

- “The legal requirement for insurance is that there be meaningful risk distribution; perfect independence is not required.”
  
Is the Product Insurance?  
Rev. Rul. 2002-90

- Revenue Ruling 2002-90 – The 12 Insured Safe Harbor
  - Captive must underwrite risk for at least 12 insureds with 5-15% of the risk
  - PLR 200724036: six insureds insufficient
- Risks should be homogenous among the insureds; arrangement should have a large pool of homogenous risks
  - Unclear this is still needed: Contradicts the portfolio theory involving risk
  - IRS requested comments in Notice 2005-49 on continued need for similar risk rule – no response from IRS in decade
  - IRS CCA 200849013: IRS failed to offer guidance on the issue
- Under Rev. Rule. 2005-40, disregarded entities will be treated as a division of their parent and will not be counted as a separate subsidiary when determining if the 12 subsidiary test is met
Is the Product Insurance?  
Rev. Rul. 2002-89

- Revenue Captive derives at least 50% of its premiums and risk from unrelated third parties
- **2002-89** forms the basis of risk pools
  - Captive manager forms a pool to which the operating business transfers 50% or more of captive’s annual premium
  - Captive will reinsure pool for the same percentage that the operating business paid into the pool, allowing it to receive all premiums paid by the operating business, minus captive manager fees
  - Once claims are paid out at end of year, balance from risk pool will be paid out to each captive – this income will not be taxable, as long as premiums for year are less than $1.2 million
  - IRS idea of risk distribution differs from courts as we will see
Is the Product Insurance?
Insurable Risk

- “Insurance risk is involved when an insured faces some loss-producing hazard (not an investment risk), and an insurer accepts a payment, called a premium, as consideration for agreeing to perform some act if and when that hazard occurs.”
- “From an insurance standpoint there is no risk unless there is uncertainty or, to use a better term, fortuitousness.”
  - Commissioner v. Treganowan, 183, F.2d 288 (2d Cir. 1950).
- “Risk for significant underwriting losses that are not related to its investment returns.”
IRS Test 2: Does Captive Look and Operate Like an Insurance Company?

- “Is it organized, operated and regulated as an insurance company by the state in which it does business?
  - Courts have emphasized significance of state regulation in determining whether an entity should be recognized as an insurance company.

- Is it adequately capitalized?
  - Minimum capital requirements of the state.
  - Adequately capitalized to pay losses.

- Are the policies valid and binding?
  - Do policies take form of insurance and contain standard provisions typical of insurance policies?
  - Insured has an insurable interest in the covered asset.

- Are premiums reasonable in relation to the risk of loss?
  - Determined through actuarial study.
  - Arm’s length.

- Are premiums duly paid and are loss claims duly satisfied?
  - Claims are made, processed and paid when losses occur.
Captive as Insurance Company: Why was the Captive Formed?

The IRS is concerned that tax drove the transaction and will look at:

• Marketing materials and all materials leading up to the engagement and formation
• Ownership of the captive versus ownership of the insured
• Again, captive needs to operate like an insurance company and at arms length from the insured
Captive as Insurance Company: Setting and Paying Premiums

• Premium payments should not be calculated to meet the $1.2 million mark – should instead be calculated to meet actual insurance needs
  – Consistent yearly premiums near the $1.2 million mark may provide the IRS with evidence of an alternative purpose to creating the CIC—that of maximizing deductions
• Premium payments should be made in same manner as commercial insurers
  – Timing of payments
• Insurer is exposed to underwriting risk – risk that premiums charged would not be enough to cover claims paid
  – This is pricing risk assumed by insurance companies in general
• Premiums must be reasonable and set by accepted actuarial and underwriting methods
Captive as Insurance Company: Coverage

- What kinds of coverage is being provided?
- IRS has reviewed captive premiums on a coverage by coverage basis:
  - Is there an insurable risk?
  - Is it being priced appropriately?
- Is the coverage otherwise available on the commercial market and if so has the insured shopped?
Captive as Insurance Company: Claims

- A lack of a substantive number and level of claims made and paid over the course of a captive arrangement’s history may be problematic—IRS will look at both the operating company and all others in the risk pool
- How are the claims processed and adjusted?
Captive as Insurance Company: Arms Length Relationship

• IRS will look for whether assets are utilized to benefit the captive owners or the insured
  – Investments-Life insurance
  – Distributions-Loans, premium rebates, etc.
  – Issues of collateralization
  – Equipment and other investments

• Loans from captive to related parties will be scrutinized and may be evidence that transaction is not at arm’s length
  – If captive makes loan to operating business, IRS will look at terms of loan, interest rate charged, rights of captive and payment history.

• Keep it formal!
Other Issues – Offshore Captives FATCA and FBAR

- Regs treat companies that make IRC § 953(d) election as not subject to FATCA as long as they are not specified insurance company
  - Still required to file Form W9
  - Specified insurance company means an insurance company that issues or is obligated to make payments with respect to a cash value insurance contract or an annuity contract
    - Also respected for FBAR purposes
- Without an election, captive will likely be a NFFE subject to reporting requirements
  - Failure to report will lead to 30% withholding and penalties
- If captive insurance company is found not to be an insurance company, the IRC § 953(d) election will no longer apply
Other Issues – Life Insurance

- Under § 264, life insurance premiums are non-deductible.
- However, a captive can purchase or leverage purchase of life insurance for operating business owner with pretax dollars allowing for tax preferred premiums.
- Not explicitly forbidden, but will draw scrutiny.
Other Issues – Wealth Transfer

- IRS/Treasury and congressional concerns abound
- Captive owned directly or through trust by or for the benefit of owner’s children or grandchildren will allow for a wealth transfer without gift, estate or GST consequences
- Treas. Reg. § 25.2511-1(g)(1): “gift tax is not applicable to a transfer for a full and adequate consideration in money or money’s worth, or to ordinary business transactions ...”
- IRC § 2036: “The value of the gross estate shall include the value of all property ... except in case of a bona fide sale for an adequate and full consideration in money or money’s worth ...”
Recent Court Decisions

- Recent case law has been taxpayer favorable as to what constitutes insurance though not specific to small captives
  - Pending cases (*Avrahami, etc.*)
Rent-A-Center v. Commissioner

• Risk shifting: Tax Court held risk shifting because RAC’s captive, Legacy, was a separate, independent and viable entity that reimbursed RAC subs when they incurred an insurable loss
  – Payment to Legacy did not reduce net worth of the subsidiaries because they did not own stock in Legacy
• Risk distribution: Three different types of risks (worker’s compensation, automobile and general liability) coupled with thousands of stores, employees and vehicles in all 50 states led the court to conclude subsidiaries had “sufficient number of statistically independent risks”
• Court did not rely on Rev. Rul. 2002-90
• Parental guaranty did not shift ultimate risk of loss
Securitas Holdings v. Commissioner

- Existence of a parental guaranty by itself is not enough to justify disregarding the arrangement
  - No amount was actually paid out under the guaranty
- Captive had 7.5 to 1.0 gross premium to surplus ratio, which was below the 4.0 to 1.0 industry standard
  - Court held this was okay because all of its risks were reinsured by a separate captive reinsurance company, so its NET premium to surplus ratio was actually 0 to 1
**R.V.I. Guaranty v. Commissioner**

- Tax Court ruled that the residual value policies were insurance for federal tax purposes.
- Tax Court found no distinction between investment risk and insurance risk related to “pure risk” and “speculative risk,” as argued by the IRS.
- Tax Court did not accept IRS argument that taxpayer did not face “timing risk.”
- In spite of very low loss ratios in the first four years, the Court looked at the loss ratio over the next 10 years and held that a 34% loss ratio was sufficient to demonstrate the taxpayer was exposed to significant loss.
- Risk shifting present because the insurance company was:
  - Well capitalized and was fully capable of paying claims, and
  - Absorbing the risk transferred to it.
- Risk distribution present because of systemic risk and additional sufficient uncorrelated risk.
Avrahami v. C.I.R

- Trial was held in March of 2015 and decision has not been issued
- IRS argues that payments from the operating business to the captive insurance company are not insurance premiums because:
  - Not insurance in commonly accepted sense
    - Not arm’s length pricing of premiums
    - Do not comply with state regulations
    - Not adequately capitalized
  - No risk distribution or risk shifting
- IRS challenges validity of insurance pool
  - Pooled risks were for terrorism coverage
- IRS argues to invalidate 953(d) election because it is not an insurance company
- IRS uses substance over form, step transaction, and economic substance doctrines
- 6662(a) penalties are sought
Recent Trends in IRS Examinations

• In captive manager promoter audits, IRS is systematically requesting information about clients of the captive managers
  – Certain clients of the captive managers are then selected for exam or contacted for information
• IRS is examining captive companies, operating companies and sometimes the individual shareholders of each
• IRS is using summons process to get the captive insurance companies to produce information in the hands of third parties
  – Internal captive manager emails
  – Communications involving representatives of the insurance pool
Recent Trends in IRS Examinations

- Audits are very fact and circumstance specific
- Risk pools may fail or may meet formal requirements but be subject to sham argument – IRS not there yet
- Even if pools meet requirements, inquiry continues:
  - We have seen clients whose internal practices and procedures expose their captives independent of the formation of the captive and practices of a manager
  - We have also seen instances in which captive managers had policies and procedures that were clearly inconsistent with what one would expect in an independent commercial insurance company
Recent Trends in IRS Examinations

- IRS has requested taxpayer interviews to verify information and ascertain facts surrounding the captive insurance company start-up and operation
- IRS is using summons process to get the captive insurance companies to produce information in the hands of third parties
  - Internal captive manager emails
  - Communications involving representatives of the insurance pool
Information Document Requests (IDRs)

- IDRs for IRC § 831(b)’s have been coordinated, meaning the same types of documents and information are being sought.
- Questions are focusing on interactions and documents exchanged between the captive manager, the operating business and the captive owners.
- The requests are broad, voluminous, overlapping and duplicative between the operating business and captive company.
  - Requesting documents and narrative responses explaining facts and circumstances of the formation and operation of the captive.
- Information requested may be in possession of captive manager, not the operating business or captive company.
- IRS then takes a substantial amount of time to review the documents and make initial determinations.
IDRs: Requests to Operating Company

• Describe and provide all marketing materials
  – State when obtained
  – Describe the circumstances under which taxpayer obtained the document

• With regard to each insurance policy, describe all losses incurred during the 10 years preceding the purchase of that policy that would have been covered under the policy had the policy been effective on the date of loss

• Identify each individual who participated in taxpayer’s decision to enter the captive insurance program
  – Provide all documents reflecting communications about the decision
  – Describe all oral communications about the decision

• Produce all documents related to captive insurance generally
  – Correspondence, emails, records, spreadsheets, forms, etc.

• Provide all claims, claim forms and supporting documentation

• Explain how taxpayer’s risks are shifted under the captive insurance program
IDRs: Requests to Captive Company

- Identify all of taxpayer’s current and former owners and state the percentage of ownership
- With regard to initial capitalization, identify each person who made a capital contribution and the amount of the contribution
- Provide all financial statements from formation to present
- Provide all documents taxpayer reviewed or relied upon in underwriting and/or pricing of the reinsurance agreements
  - Actuarial tables, historical loss cost data, industry data, memoranda, notes and correspondence
- Provide all documents related to or reflecting taxpayer’s investment of premiums
- Provide all reinsurance agreements and binders
- Provide documentation of all claims and invoices
- Explain how taxpayer distributes risk under the captive insurance program
IRS Examinations: Interviews

- IRS is sometimes doing exhaustive (and exhausting) interviews
- IRS will use information gathered in the interview and through original document request to identify additional potentially troublesome documents and request them
- They will compare what you have said to what you have given them or what they have gotten from third parties….care is necessary
Sample Interview Questions and Topics

• Regarding the insured
  – History of the business
  – Ownership, and any changes in ownership
  – Reason for ownership of captive
  – Was legal advice obtained?
  – Financial position prior to captive
  – Management discussions regarding risks prior to formation of captive
  – Types of events trying to protect against
  – Other steps to address this risk
  – Were premiums and coverage prices compared? Did you shop for commercial coverage?
  – Did you have losses in years prior to entering captive that would be covered by that coverage?
Sample Interview Questions and Topics

• Interaction with captive manager
  – How did you find the captive manager? Did you consider different managers?
  – Describe your interaction with the captive manager before and after starting the captive. How often? What was discussed?
  – What marketing materials were you provided? Are these consistent with oral statements made by the captive manager?
  – What do you know about the distribution of risk? Risk shifting?
  – What did the captive manager tell you about risk pooling? Any discussion of likelihood of pool claims? Guarantees against claims? Information of other companies in the pool?
  – What were you told about tax advantages? Deduction of insurance premiums? Exclusion of premiums from income at captive and 831(b)?
  – What were you provided explaining the premiums? Actuarial report? Underwriting?
Sample Interview Questions and Topics

- Operation of the captive
  - Describe the investment of funds in the captive. Any guidance provided by captive manager regarding investment?
  - Explain the specific policies and what you are protecting against, as well as any exclusion.
  - Explain changes in policies or coverage through the years. Any discussions regarding changes? Documentation?
  - How long do you expect to participate in the captive program?
  - Were you concerned about the potential pool claims?
  - Has the captive made any distributions of income?
  - Have there been any direct claims? Any claims from the pool?
  - How are claims processed?
  - Any claims denied? Any losses that could have been claimed but weren’t?
  - Does the captive have any paid employees?
  - Explain high premiums. Premiums higher than limit?
IRS Interviews: Best Practices

- See if you can find others who have been through this process
- Identify potential questions
- Review documentation and facts
- Identify and gather any additional documents to support your story
- Be prepared to tell your story
- Slow and easy does it—with breaks whenever you want them
- If they record…so should you
- Do not do it without representation sitting next to you
IRS Examinations: Possible Negative Results

• If pool or captive invalidated, loss of § 162 deduction for premiums paid by operating business
  – IRS may attempt to tax the premiums at the captive insurance company
• Possible penalties
  – § 6662 accuracy related penalties
  – § 6694 preparer penalties
  – Economic Substance?
  – Other
• IRS finding that risk pools do not distribute risk can have far reaching implications for captive owners
  – If the IRS were successful in efforts to invalidate a pool, all of its members are impacted
• State tax and insurance issues
Before the IRS Arrives: Safeguards

- There are a series of things you can do to better your position if the IRS later shows up
- Ensure that risk management is primary driver of transactions and that the documents reflect this
- FORMALITIES MATTER! Make sure everything is documented. All meetings and discussions.
- Have substantive conversations with your captive manager each year about what is and is not covered and about premiums
  - Determine if the type of coverage is necessary
  - Determine if the amount of coverage is necessary
  - Add or delete coverages as your business dictates
  - Know when and how to file claims
- If something appears too good a deal….it likely is!
Before the IRS Arrives: Safeguards

- Pick coverages that will likely result in regular claims activity in addition to disaster type coverages – for example, coverage for your deductibles on your commercial insurance
- Do not hesitate to make claims
- Invest in liquid assets so they are available in the event of large losses
- Limit the type of activity that will create IRS interest (e.g., loans, life insurance, constant churning of reserves through dividends, setting of premiums in line with year’s taxes)
QUESTIONS?
Thank you.

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