

# Enterprise Risk Captive Market Update - 2021

Jeffrey K. Simpson, Partner  
Womble Bond Dickinson (US) LLP  
1313 North Market Street  
Suite 1200  
Wilmington, DE 19801  
D: 302-252-4371  
M: 302-521-6191  
Jeff.Simpson@wbd-us.com



# Outline

Defining Enterprise Risk Captives (ERCs)

IRS Campaign Against ERCs

Recent Developments with IRS

Other Industry Response and Activity

Where ERCs Are Headed

# Defining Enterprise Risk Captives

## Common Definition of Enterprise Risk Management:

- The process of planning, organizing, leading and controlling the activities of an organization in order to minimize the effects of risk on the organization's capital and earnings
- Enterprise Risk management includes financial, strategic and operations risks, in addition to risks associated with accidental losses.

## Enterprise Risk Captive:

- A captive insurance company that addresses risks not typically included in commercial insurance programs

# Defining Enterprise Risk Captives

## Industry/SIIA Definition (Good)

- Captive serving small or middle market private company
- Insuring risk not typically included in commercial insurance programs
- Elects 831 (b) treatment

## IRS Definition (Bad)

- 831 (b) a/k/a micro-captive that:
  - Insures bogus risks
  - At inflated premiums
  - And pays no claims
  - To maximize tax benefits

# IRS Campaign Against ERCs

## Dirty Dozen

- 2015, 2016, 2017, 2018, 2019, 2021
- Focused on consumer scams in 2020

## Transactions of Interest

- Notice 2016-66
- Promoter Investigations (new office 4/19/21)

## Audits

- 12 New Teams
- “Soft” Letters (6336)

# IRS Campaign Against ERCs

## The Cases:

- Avrahami, 149 T.C. 144 (2017)
- Reserve Mechanical, 115 T.C.M (CCH) 1475 (T.C. 2018)
- Syzygy, 117 T.C.M. (CCH) 1165 (T.C.2019)
- Caylor, 121 T.C.M (CCH) 1205 (T.C. 2021)

# Recent Developments

## IRS vs DEDOI

- IRS sued DEDOI in Federal Court in DE
- Compel production of all email communication between DEDOI and Artex/Tribeca
- Court held
  - McCarran Ferguson limited to “business of insurance”
  - “Business of insurance” limited to relationship between insurer and policy holder
  - Section 6920 confidentiality available only for “business of insurance”
  - Requested records NOT “business of insurance”
  - Records must be produced

# Recent Developments

## IRS vs. DEDOI

- DE has appealed to 3d Circuit
  - Court used wrong standard for “business of insurance”
- DE needs industry support – Amicus Briefs
  - Standard for “business of insurance”
  - Inconsistent with NAIC model laws
  - Chill on onshore captives



# Recent Developments

## CIC vs IRS

- Success at U.S. Supreme Court!
  - Anti-Injunction Act does not preclude the challenge
- Return to trial court
  - Motions to block enforcement of Notice 2016-66
    - Granted as to CIC
    - Pending as to industry
  - Trial – did IRS comply with Administrative Procedures Act?
    - What is result if IRS did not?

# Recent Developments

## Puglisi v IRS

- Puglisi Egg Farms (NJ & DE)
- Captive with Oxford Risk Management Group in DE
- In discovery, preparing for trial
- IRS conceded all taxes and penalties (October 29, 2021)
  - Effective for years at issue (2015-2018)
  - And subsequent years (at least 2019-2020)
- Puglisi resisted concession
  - Wanted ruling on the merits
  - Didn't get one

# Industry Response and Activity

## Amicus Briefs

- Unprecedented cooperation and coordination among industry associations
- First Avrahami – SIIA – Terrorism Risk is Real
- Lately:
  - Reserve Mechanical - Prior Loss, Cookie Cutter Policies, Equal Premium In and Out of Pool
  - CIC - Impact on Industry
- Next: IRS v DEDOI?

# Industry Response and Activity

## Ongoing Advocacy

- Continuing to build influence in DC
  - Lobbying and intelligence collection
  - Meetings with congress and staff
- Telling captive owners' stories – media
- Coordination of industry associations

# Where ERCs Are Headed

## COVID Pandemic

- New York Times (5/29/20) – “Once Scrutinized, an Insurance Product Becomes a Crisis Lifeline”
- SIIA 2021 captive survey
  - Average of 75 Covid claims per captive manager
  - 80.5% of claims paid
  - Average claim value of \$650,000  
(Largest was \$2,000,000)
  - Vindication of Purpose?

# Where ERCs Are Headed

## Hard market

- More emphasis on traditional vs non-traditional risk
- Surge in P&C and medical stop-loss programs
- More educated/interested middle market
  - Plus more access thanks to creative design
- SIIA 2021 Captive Survey
  - In 2020, average captive manager formed 28 and closed 21
  - Several dozen managers participated
    - 3789 total captives under management
    - Typical profile is 50-65 captives under management

# Where ERCs Are Headed

## Fighting IRS

- Expect continued scrutiny & pejorative rhetoric
- SIIA 2021 captive survey
  - 35% of managers with one or more captives under audit
  - 2 reported no-change letters
  - Pressure to settle
    - Less favorable terms over time
    - No sympathy from appeals
    - Mixed reports on clients' willingness to settle
      - Many of those who do settle think the settlement does not reflect the merits of their case
- IRS deliberately keeping good facts out of court
- High costs
  - Defense average \$150,000
    - Range \$30,000-\$250,000
  - Total \$3 million per manager

# Where ERCs Are Headed

## Need a winning case

- Only thing that can corral IRS
- Establish boundaries and guidance
  - So far, only know what doesn't work
- Required elements (in my opinion!)
  - Engaged owner
  - Business purpose – record of trying to solve an insurance problem
  - Multiple owner claims
  - Pool with frequent claims
  - Actuarial pricing
  - Committed manager with funding support



# Where ERCs are Headed

## What Can Industry Participants Do?

Help in the Fight – Contribute time, dollars, and influence

Stay active locally

- Engage your regulators
- Engage your home state federal delegation  
(esp. captive states)

Tell your story

- Volunteer for press
- Go to DC

Join the national associations

- Bring your clients too

# Conclusion

**Very Active time with IRS**

## **The way ahead**

Continue involvement with state associations

Support of national industry associations

Engagement and diligence with best practices

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