

CAPTIVE TAX UPDATE WITH FOCUS ON THE LAST FOUR MONTHS

Kentucky Captive Insurance Association

Annual Meeting

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Scope of Slides and Comments

This presentation and these slides are for general information and are not tax advice. If you have questions about the tax consequences to your particular situation, please consult your tax professional.

Agenda

1. What you want to know – ask questions
2. Three fundamentals of captives
3. Tax tests
4. “Dirty Dozen” and Notice 2016-66
5. IRS says some small captives are good
6. Treasury does not have sufficient information
7. Notice 2016-66 abusive indicators
8. Audits and Appeals
9. Litigation, including Syzygy Insurance
10. CICA Paper and Other Industry Activities
11. Final thoughts

Three Fundamentals of Captives

- Non-Tax Business Purpose
- Want to Be in the Insurance Business (share and assume risk)
- Operate the Captive as an Insurance Company (follow formalities and act as an unrelated insurance company would)

Tax Tests

- Non-Tax Business Purpose
- Insurance Risk
- Risk Shifting
- Risk Distribution
- Insurance in its Commonly Accepted Sense

The IRS is concerned about Abuse and Small Captives

- IRS Challenges Small Captives (section 831(b) and 501(c)(15))
 - The IRS has expressed concern about abuse and small captives
 - “Dirty Dozen” IRs 2015-19, 2016-25, 2017-31, 2018-62, 2019-47
 - Notice 2016-66 (confirmed by Sixth Circuit in Mid-May 2019)
 - Most arrangements involving section captives electing section 831(b) are designated as Transactions of Interest
 - Less than a 70% Loss Ratio
 - Captive provides loans or pledges to, or for, affiliates
 - Five year look-back
 - Captive, insured, owners of pass-through insureds
 - Material advisors
 - Required that a catch-up be filed by March 1, 2017
 - Annual filings thereafter

IRS agrees some small captive arrangements are good

- IR 2015-19 and 2016-25 : Another abuse involving a “legitimate tax structure” involves certain small captives
- All IRs: Tax law generally allows businesses to create “captive” insurance companies to insure against certain risks.
- Notice 2016-66:
 - The Treasury Department and the IRS recognize that related parties may use captive insurance companies that make elections under § 831(b) for risk management purposes that do not involve tax avoidance ...
- 1.9100 relief for late filed section 831(b) elections
- Syzygy: Section 162(a) does not prohibit deductions for microcaptive insurance premiums

Treasury and IRS lack sufficient information

- Notice 2016-66:
 - The Treasury Department and the IRS believe this transaction (“micro-captive transaction”) has a potential for tax avoidance or evasion. *See* IR–2016–25 (discussing characteristics of an abusive micro-captive insurance structure). However, the Treasury Department and the IRS lack sufficient information to identify which § 831(b) arrangements should be identified specifically as a tax avoidance transaction and may lack sufficient information to define the characteristics that distinguish the tax avoidance transactions from other § 831(b) related-party transactions

Notice 2016-66 Abusive Indicators

- **Contracts:**
 - covers implausible risks, no business need, vague or illusory coverage, duplicates commercial coverage
- **Premiums:**
 - wants deduction, no industry standard underwriting or actuarial analysis, not paid per payment schedule, no competitive premiums sought, significantly excessive premiums, improper intercompany allocation
- **Claims and management:**
 - Captive does not follow statutory and regulatory requirements, not timely issue policies and binders, claims procedures not consistent with industry standards, insured does not file claims for each loss
- **Capital**
 - Inadequate capital, invest in illiquid or speculative assets, loans to affiliates

IRS Audits/Appeals

- Exhaustive IDRs (Information Document Requests)
 - All emails, brochures, marketing material, conversations, tax advice received
 - How did you learn about the captive, next actions, persons consulted
 - Commercial policies, risk management, pricing, prior losses, investments
- Exam Insurance Specialists
- Number of audits, etc.
 - IR-2019-47: more than 500 docketed cases in Tax Court, numerous income tax examinations and promoter investigations
- Section 953(d) issues?
- LB&I “campaigns”, one of first 13; campaign materials to be released
- Coordinate with SBSE, Counsel; use IDRs in large captive audits?
- Tax Shelter Promotion Investigations
- Appeals, Insurance Specialists
- Global Settlement ?

Litigation

- Avrahami v. Commissioner (149 T.C. 144 (2017)) – not appealed
 - Government won – Disallowed deductions for insurance premium
 - no risk distribution
 - not insurance in its commonly accepted sense
 - no penalty – good faith reliance on tax advisor; guidance not clear
- Reserve Mechanical v. Commissioner (T.C. Memo. 2018-86) on appeal
 - Government won – Captive received taxable income
 - no risk distribution
 - not insurance in its commonly accepted sense
 - no penalty asserted
- Syzygy Insurance v. Commissioner (next pages)
- Cases tried and awaiting opinions from the Tax Court
 - Caylor Land Development v. Commissioner
 - Wilson v. Commissioner

Syzygy Insurance

- Syzygy v. Commissioner T.C. Memo. 2019-34 (April 10, 2019)
 - Taxpayer had burden of proof
 - Insured bought policies from Fronting Company (the pooling entity), which reinsured the lower layer to the affiliated captive, and a pro-rata share of pool participants' upper layers to the affiliated captive
 - Fronting Company must be a bona fide insurance company:
 - Created for non-tax reasons?
 - Circular flow of funds?
 - Actual and insurable risks?
 - Policies are arm's-length?
 - Actuarially determined premiums?
 - Whether comparable coverage was more expensive or available?
 - Met regulatory requirements?
 - Adequate capitalization?
 - Claims paid from a separately maintained account?

Syzygy – Risk Distribution

- Circular Flow of Funds
 - Insured paid Front \$1,373,500; Front ceded \$1,319,055.76 to Captive
 - Cited Avrahami and Reserve Mechanical re: circular flow of funds
- Arm's-length Coverage
 - Rate on line for captives vs commercial policies (6.1% v 1.14%)
 - Excess coverage should be priced lower
 - No refund on cancellation of policies
 - Short period in which to file claims
 - Taxpayer switched its captive manager because premiums decreased
- Actuarially Determined Premiums
 - Premiums by underwriter who did not have an actuarial rating model or price comparison; at one point, he said premiums were wild guess
 - Ratio of 49% (lower layer) and 51% (upper layer) not actuarially determined
- Front not valid, thus no risk distribution

Syzygy – Insurance as Commonly Accepted

- Whether Captive is organized, operated and regulated as insurer
 - Properly organized and regulated
 - The question is whether the Captive was operated as an insurance company
 - Insured did not file \$100,000 of claims for deductible reimbursement
 - More than 50% of the assets were invested in illiquid split dollar life insurance
 - Captive manager did not testify
- Minimum capitalization met, which is sufficient
- Valid and binding Policies – weighs against taxpayer
 - Centers on whether policies were timely issued, identified the insured and specified what was covered
- Reasonable Premiums – weighs against taxpayer
- Payment of Claims – slightly in taxpayer's favor
- Syzygy was not operated like an insurance company

Syzygy – Other Issues

- Non-insurance premiums may be deductible indemnification payments, but not here, where the insured did not file numerous claims
- Rev Ruls 2005-40 and 2008-8 provide these alternatives (in addition to indemnification payments): loans, deposits and capital contributions (to the extent of net value)
- Commissioner must follow applicable Revenue Rulings
- No evidence that recharacterization is appropriate
 - Arrangement is not insurance therefore 831(b) election is invalid
 - Captive must recognize premiums it received as income
- No Penalties:
 - Reliance on CPA's professional advice
 - Avrahami looked at lack of precedent in finding good faith
- Appeal?

CICA Paper and Other Industry Activities

- CICA Paper – March 2019
 - Pools
 - Equal amount of premiums in and out
 - Commercial policies for multiple entities
 - Commercial coverage and captive coverage
 - Outside service providers
 - No requirement of prior loss
 - Vehicle service contracts
 - Standard policy language
 - Setting premiums
- Litigation
- SIIA – legislative and administrative activity
- American Bar Association
- CIC vs US – Sixth Circuit upheld Notice 2016-66 by 2-1 vote

Final Thoughts

- What is a good arrangement?
 - Non-Tax Business Purpose
 - Risks Insured
 - Pricing
 - Claims
 - Investments
 - Regulation
 - Capital
 - Ownership
 - Documentation