

## **831(b) Captive Insurance Company Tax, Legal and Financial Issues, Controversies and Solutions**

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### **Introduction**

Over the next several years, the new “economic substance” test combined with the rapid growth in small US insurance companies may help clarify continuing uncertainties regarding taxation of US captives. Both public and private sector industry leaders are starting to establish guidelines on complex issues but not on an industry wide basis. Since this industry builds captives, it is fitting the industry develop guidelines as the building industry drove uniformity in building codes. Legal, tax, audit and management leaders should gather and contribute to guidelines to assure small captives being submitted to the various domiciles are modeled to meet not only formation requirements, but to meet the financial audit reporting standards on tax positions and expected IRS requirements on review for deductibility of premiums by insureds. This will protect the gains in small business job growth, and the increased stability and competitiveness occurring with wider use of 831(b) insurance companies by more small to medium sized private companies (SMBs).

### **The New Economic Substance Test**

Regarding the impact of the new codified “economic substance” test, section 1409(a) of the 2010 Health Care Act added IRC section 7701 (o) to resolve the longstanding conflict among circuit courts on how the “economic substance doctrine” should be applied. The new statute states:

“In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction.”

The act imposed new strict liability minimum penalties for transactions not meeting the economic substance test. The arm’s length standards of section 482 apply and could cause re-characterization in related party transactions.

In future IRS reviews of captives and insureds paying premiums to related party captives, it is likely the new economic substance test of section 7701 and section 482’s arm’s length tests could be used to make adjustments and perhaps invoke penalties and interest. This two pronged economic substance test is not supposed to override the extensive prior court cases that developed the economic substance doctrine, but the statutory language appears to increase the factors needed for a finding of economic substance over most reported court decisions.

Whether IRS agents use this new statute to increase the bar on what is required to meet the economic substance tests of the courts, and whether it will be used to increase requirements on risk shifting and distribution issues, will hopefully be known soon.

### **Related US Tax Law Controversies Looming**

IRS and US Department of Treasury pronouncements over the past several years are gaining increased attention as more small captives emerge. Small company captives face greater challenges in meeting

risk shifting and risk distribution requirements than do larger national and international corporate groups.

The IRS issued a series of pronouncements since Rev. Rul. 2005-40 aimed to make it more difficult to meet the risk distribution safe harbor requirements of earlier revenue rulings. Rev. Rul. 2005-40 will likely be found incorrect when tested in the courts. The reason is simple - because they fail to apply substance over form economic standards long honored and espoused by the courts in developing the economic substance doctrine. The more recent IRS advisory memos indicating separate limited partnerships with the same general partner will be treated as one entity also ignore legal liability and economic substance elements impacting risk shifting and risk distribution.

When it suits the IRS to look through the form of a transaction to see if it has economic substance, such as in Rev. Rul. 2009-26 where they looked through a reinsurance arrangement to the risks of the ultimate insureds, and in an IRS Chief Counsel opinion finding adding general contractors as additional named insureds to a policy did not add risk distribution where the subcontractor acts were at issue and already covered, the IRS is quick to put great weight on economic substance characteristics or lack thereof to contractual relationships.

However in Rev. Rul. 2005-40 (disregarding single member LLCs that have distinct balance sheets and different business risks) and TAM 200816029 (consolidating legally separate partnerships due to a common general partner), the IRS clearly ignores the economic substance of the contractual relationships. These released pronouncements are totally in contradiction to decades of US court analysis focused on economic substance and fairness and underlying the economic substance doctrine which the new statute codifies. Just as many tax attorneys, based on interpretation of a long line of case law, advise clients they can meet risk distribution requirements with as few as 7 affiliated entities (and with premium allocations as high as 30% to one entity), versus 12 in number (and no more than 15% of premium to one entity) as specified in the IRS safe harbor Rev. Rul. 2002-90, many tax attorneys are also advising clients the IRS is wrong in Rev. Rul. 2005-40 and TAM 200816029.

Hopefully this new codification of the Economic Substance Doctrine will help both captive industry advisors and the IRS to increase focus on the substance, not the form, of transactions. It certainly seems in the US economy's best interest to allow SMBs to strengthen themselves and extend expertise in enterprise risk management and other business survival sciences.

### **Industry Political Observation**

As a captive industry newcomer in 2011, I have frequently heard industry veterans and read material online on websites and in blogs criticizing the growth in 831(b) captives. This criticism stems mainly from a fear that some captive promoters over-emphasize tax advantages and under-emphasize the economic substance and non-tax business purposes of captives.

This brings to mind Ben Franklin's famous quote "...we must all hang together, or assuredly we shall all hang separately." The larger insurance industry has for more than 20 years played a major role in US tax legislative policy, ranking 6<sup>th</sup> out of 80 industries in campaign giving in 2009; It ranked 2<sup>nd</sup> in lobbying expense in 2009. Despite the weight of the insurance industry generally in US tax legislative affairs, captive service providers and state captive regulators need to be particularly supportive of the captive industry's growth as the larger insurance industry and lobby will not be paying much attention to the special needs and interests of a healthy captive industry.

Broader use of captives, particularly by SMBs, should be encouraged even if the 831(b) incentive is what ultimately encourages many SMB management teams and owners to initiate a captive program. The captive industry must not forget that Congress intended these benefits to encourage increased liquidity and savings to cover risks by SMBs, just as they have enacted other provisions to encourage people to save for retirement.

Many economists agree that most innovation and job growth in the US will come from this SMB sector; it naturally flows that anything that strengthens SMBs is a good thing. If the captive industry speaks in a unified voice in support of section 831(b), it will be preserved for a long time. It seems clear the industry is reacting to establish reasonable guidelines on the design, scope and application of future 831(b) captives, including useful formulas for guiding the ratio of premiums to business enterprise size on the expanding universe of enterprise risk and other types of coverages.

Since this industry builds captives, it is fitting the industry develop guidelines as the building construction industry drove uniformity in building codes across the 50 states. Legal, tax, audit and management leaders should gather and contribute to guidelines to assure small captives being submitted to the various domiciles are modeled to meet not only formation requirements, but to meet the financial audit reporting standards on tax positions and expected IRS requirements on review for deductibility of premiums by insureds. We have observed a wide range in quality of corporate governance documents as well, particularly with respect to complex legal structures like cell and series captives and with respect to the observation of long established private offering protocol and documentation. Some collective industry effort to create appropriate industry templates, or at least formation checklists, seems indicated in these areas as well to protect industry interests to minimize future litigation and tax controversies.

Despite most of these small captives starting off initially heavily reliant on tax advantaged loss reserve build-up, these smaller companies over time gain expertise and comfort with a captive and then expand risk management initiatives part of the captive program. This ultimately enables SMBs to be more competitive, strengthens their capacity to absorb risks, and enables building loss reserves that will protect them from hard cycles in the commercial insurance underwriting markets as well as from catastrophic risks which can and do occur. Just as the US Congress enacted tax deferral provisions to encourage those with sufficient income to set aside retirement savings, 831(b) was enacted to encourage profitable businesses to save and build loss reserve assets which in many ways strengthen businesses as retirement savings strengthen families.

These 831(b) captives may prove in time to be the reason many SMBs can continue to afford, and why many may start to offer, meaningful and affordable employee health, vision and dental insurance in the future. The entire industry should encourage their expanded use. Experienced managers should even consider creating an industry sub-committee to establish 831(b) design criterion and guidelines to assist others in the industry. This proactive approach could help assure future 831(b) captives meet an industry collective view of economic substance. This could also end up proving to be a guide for the Internal Revenue Service's audits of captive insurance companies.

**About the Author:**

\*Tom Cifelli, JD, CPA, is Managing Editor of CaptiveExperts.com and works with leading global captive managers on captive research, design and formation issues.