

## **Documenting the Non-Tax Business Purpose and Economic Substance of 831(b) Captives – Impact of the New Codified Economic Substance Doctrine**

May 3, 2013 by Thomas A. Cifelli

### **Excerpt:**

In 2010 Congress added Section 7701(o) to the Internal Revenue Code. Section 7701(o) codifies the “substance over form” and “step transaction doctrines” developed under the umbrella of economic substance tests by court decisions in tax dispute cases since the U.S. federal income tax began in 1913.

This is particularly important for captive insurance companies since statutory tax preferences and incentives are often important considerations in the formation of a captive. New strict liability penalties starting at 20% apply if a transaction fails to meet the new two-pronged economic substance doctrine tests. When designing and operating a captive insurance company, especially 831(b) captives, extra attention is needed to document all non-tax economic and business purposes and benefits.

### **Statutory Language:**

The Health Care and Education Reconciliation Act of 2010 added IRC section 7701(o) that reads as follows:

#### **“(o) Clarification of economic substance doctrine**

##### **(1) Application of doctrine**

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 such transaction.

##### **(2) Special rule where taxpayer relies on profit potential**

###### **(A) In general**

The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

###### **(B) Treatment of fees and foreign taxes**

Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

##### **(3) State and local tax benefits**

For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

##### **(4) Financial accounting benefits**

For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

**(5) Definitions and special rules**

For purposes of this subsection—

**(A) Economic substance doctrine**

The term “economic substance doctrine” means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

**(B) Exception for personal transactions of individuals**

In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

**(C) Determination of application of doctrine not affected**

The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

**(D) Transaction**

The term “transaction” includes a series of transactions.”

Other provisions of the Reconciliation Act of 2010 added strict liability penalties applicable if a transaction is determined to lack economic substance. These penalties start at 20% of the tax deficiency, and go as high as 40%.

**Application to Captives:**

Expect the new 7701(o) provisions to be applied on captive audits. Section 7701(o)(5)(C) states the law applies only to transactions where the economic-substance test is relevant. The Joint Committee on Taxation’s report states:

The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. [Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination with the “Patient Protection and Affordable Care Act”* (JCX-18-10), p. 152 (March 21, 2010)]

One example cited by the report to which the economic-substance doctrine was not intended to apply was the choice to use a related-party entity in an arm’s-length transaction. The Joint Committee stated:

If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. [Id., at 152, n. 344]

As discussed below, the courts have applied business purpose and economic substance tests in prior captive cases. So it follows the economic-substance doctrine will be applied to captives, especially licensed small insurance companies electing to take advantage of 831(b), a congressionally created and intended small insurance company tax incentive. Congress clearly intended that 831(b) captives in particular be afforded special tax benefits to encourage businesses to segregate risks in a separate tax incentivized insurance entity. Therefore we do not expect the new 7701(o) tests to cause any increased scrutiny of 831(b) captives. If the Treasury and IRS determine 831(b)’s tax revenue costs outweigh the

economic, business and job growth benefits, they are more likely to appeal to Congress to modify or revoke 831(b) rather than cause a flood of related tax controversy cases based on the new statute.

#### **Treasury Department and IRS Guidance:**

In September 2010, the Internal Revenue Service ("IRS") released Notice 2010-62 (the "Notice") providing limited clarification with respect to certain aspects of Code section 7701(o) and the related penalty provision. The Notice, however, also stated that neither the Treasury Department nor the IRS intends to issue general administrative guidance regarding the types of transactions to which the Codified Economic Substance Doctrine does or does not apply and the IRS will not issue private letter rulings or determination letters with respect to whether economic substance is relevant to any transaction or whether any transaction complies with the requirements set forth in Code section 7701(o). In the same month, the IRS Large and Midsize Business Division ("LMSB"), issued a directive (the "2010 LMSB Directive") that, to ensure consistent administration of the Economic Substance Penalty, any proposed penalty must be reviewed and approved by the appropriate Director of Field Operations ("DFO"). No further guidance was given as to how a DFO should evaluate proposed penalties for transactions lacking economic substance. This limited guidance has left taxpayers and tax practitioners without clarity as to the intended scope of Code section 7701(o) or if any transactions are exempt from its application. /<sup>2</sup>

#### **Captive Design and Documentation Implications:**

##### ***Feasibility Studies***

Forming a captive is generally preceded by a feasibility and actuary study. All such documents should be reviewed and as necessary updated to clearly articulate all non-tax business and economic purposes and benefits of the captive insurance company program. In particular, language should be included that lays out various non-tax ways that formation of a captive will change the economic position of the "sponsoring" affiliated insured operating businesses. The study language should also clearly list as many substantial non-tax business purposes for creation of a captive program as possible.

##### ***Business Plans***

All captives prepare and submit business plans to insurance regulators in connection with applying for an insurance license. Few however update the business plan unless required by the regulatory domicile. As with feasibility studies, all business plans should be reviewed, and as necessary updated, to clearly articulate all non-tax business and economic purposes and benefits of the captive insurance company and the resulting changes in economic position from such enterprise risk management programs. Updated business plans should reference the actual non-tax impacts the captive program has had on operating affiliate companies including the business and wealth protection benefits.

##### ***Operational Reports & Corporate Minutes***

Well managed captives have ongoing meetings and discussions that should be documented. These regular periodic operational meetings should address matters including but not limited to claims activity, risk assessment, lines of coverage, policy term review, investment strategy, loss control activities and financial performance. These ongoing meetings and reports should be well documented, along with all captive governing board and owner's meetings. Meeting agendas and minutes should specifically discuss non-tax business and economic goals and objectives to additionally document compliance with the new codified economic-substance doctrine.

### ***Independent Strategic Review***

While not typically part of captive management and governance processes, now that independent service providers exist who are offering strategic captive reviews at affordable prices, owners of 831(b) captives who want to better prepare themselves for an IRS inquiry regarding the economic substance of their captive program should seriously consider engaging an independent 3<sup>rd</sup> party to perform a strategic review targeting the economic substance and non-tax business impacts of the captive. Such an exercise should improve captive operations, and could very well prove invaluable later if a tax audit arises questioning the economic substance of a captive lacking regular and material claims activity.

### **General Discussion:**

Most commentators have concluded that the codified economic substance doctrine does not modify existing common law. Its future application by the IRS is uncertain due to it encompassing some, but not all, of the applicable common law.

The most conservative approach is to assume the new codified provisions will be applied as additional tests to those articulated by existing case law.

The IRS has specifically refused to limit the potential application of the new codified doctrine. It has however indicated it will issue regulations or rulings attempting to establish more guidance on when it will attempt to disallow tax benefits based on the economic substance doctrine.

***The greatest concern about this new codified two-pronged test*** is that it could invalidate a large number of previously normal transactions designed to take advantage of specific statutory tax incentives. Many corporate transactions are designed specifically to minimize taxation and the tax savings the most significant immediate economic benefit. Historically this was considered good tax planning, not abusive tax evasion.

The legislative history during debate on the Reconciliation Act of 2010, while not law or binding on the IRS, suggest tax benefits should not be disallowed even if a transaction fails the new test if the transaction is consistent with other applicable provisions of the Internal Revenue Code and the purpose of those provisions. The legislative history clearly states transactions designed largely or entirely on comparative tax advantages that historically been judicially and administratively respected should continue to be despite failing the new codified tests.

As applied to captives, especially those designed to meet the requirements for and take advantage of 831(b)'s special election, advisers should be concerned about but not paralyzed by the new economic substance doctrine. It specifically can be applied to a series of transactions. If captives are designed as tax leveraged wealth accumulation vehicles with minimal risk of any material loss claim activity, the IRS audit staff could very well attempt use of section 7701(o) to deny the tax benefits of section 831(b) and assess 20% or higher penalties and interest; However this would clearly be unreasonable where a captive insurance company is licensed and conducting an insurance business.

Attorney Jeffrey T. Sheffield in March 2011 published an article in CCH's ***Taxes-The Tax Magazine*** which concludes with a powerful question, "It will be interesting to see whether this codification and related penalty regime will have any lasting effect on corporate transactional tax practice or, much like the partnership anti-abuse regulations issued in the late 1980s, serve simply as a powerful but little used weapon in the government's arsenal against tax shelters." /<sup>1</sup>

### **Underlying Common Law Summary**

To better understand how to navigate 7701(o)'s 2 prong test, some case law involving the business purpose and economic benefits of captive transactions is useful.

A Sixth Circuit case, *Humana Inc.*, 881 F.2d 247 (6th Cir. 1989), discussed the business purpose with respect to captive insurance companies. This case involved a hospital group that formed a captive to provide insurance for the parent and brother-sister subsidiaries. Although the court addressed business purpose, it did not explain what it was. The court held that "Health Care Indemnity was formed for legitimate business purposes. Health Care Indemnity and the hospital subsidiaries conduct legitimate businesses and are devoid of sham. No suggestion has been made that the premiums were overstated or understated." This case shows that at least some form of business-purpose test has historically been applied to captives by the courts.<sup>3</sup>

In *United Parcel Service of America, Inc.*, 254 F.3d. 1014 (11th Cir. 2001 reversing a Tax Court decision), the IRS argued that United Parcel Service (UPS) premium payments to National Union Fire Insurance Co. (National Union) for insurance on excess-value packages should be gross income to UPS because there was no business purpose to the transaction, the charges were above the norm, and the main motivation of the transaction was tax avoidance.

The Eleventh Circuit determined that the kind of economic effect required for this type of transaction was whether the arrangement resulted in "genuine obligations enforceable by an unrelated party." The court found that the contract between UPS and National Union gave National Union the right to receive the excess-value charges and that National Union had assumed the risk for losses on the excess-value shipments. The court stated that "[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance." It noted that the Tax Court did not find that there was any business purpose in the transaction because the excess-value business operated effectively the same before and after the restructuring. The court concluded that the business-purpose test was met if the transaction was part of a "bona fide, profit-seeking business" and that it did not require the transaction to be "free of tax considerations." This case addressed both economic effect and business purpose. Based upon Notice 2010-62 discussed above, it appears this case still has relevance in applying the new section 7701(o).<sup>3</sup>

### **Reference Sources:**

1. "Corporate Transactions and the Economic-Substance Doctrine," Taxes-The Tax Magazine, March 2011, Jeffrey T. Sheffield.
2. Bracewell & Giuliani website, <http://www.bracewellgiuliani.com/news-publications/updates/irs-issues-guidance-application-codified-economic-substance-test>.
3. *The Codified Economic-Substance Doctrine and Captive Insurance Companies*, Tax Clinic, September 1, 2012, William F. Buechler and Frank O'Connell.
4. "Economic Substance," by David M. Repp, Dickinson, Mackaman, Tyler & Hagen, P.C., Des Moines, Iowa (undated memo).
5. "Clarifying (Or Is It Codifying?) the 'Notably Obtruse': Step Transactions, Economic Substance, and the Tax Code," Philip Sancilio, Columbia Law Review article, January 2013.
6. "Codified Economic Substance Doctrine: You'll Know It When You See It?," Carol Tello, Jeff Friedman and Ken Jones, Sutherland, Asbill & Brennan, LLP, webinar power point, March 30, 2011.
7. 26 USC section 7701(o).