Newly Codified US Economic Substance Test Application to 831(b) Captive Insurance Companies

Introduction

Rapid growth continues in formation of small US insurance companies by increasing numbers of small to medium sized businesses (SMBs) to address rising awareness of the seriousness of uninsured enterprise risks and the long-term business benefits of captive programs. The new codified "economic substance" test could encourage Industry leaders to accelerate establishing guidelines that protect against imprudent practice standards in engineering 831(b) captive applications. Since this industry builds captives, it is fitting they develop design guidelines internally as the construction industry did by developing uniform building codes for adoption across the US. Industry endorsed captive deign and application guidelines could help assure future small captives meet the new economic substance tax test and help protect the job gains and increased stability and competitiveness of SMBs that result by expanded use of 831(b) captive insurance companies.

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 captives, the new economic substance test of section 7701 could be used to make adjustments and 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.

It will be interesting to see if this new codified economic substance test impacts CPAs application of FASB Interpretation (FIN) 48, *Accounting for Uncertain Tax Positions*. FIN 48 has made it imperative for CPAs to assess and disclosed in audit reports and footnotes if any transaction may expose the business to tax liabilities, penalties and interest. Auditors of small captives and of insureds paying premiums to small captives would find comfort in published design standards where they do not have opinions of tax professionals or private letter rulings to rely upon.

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), verses 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 some 831(b) captive programs. This criticism stems mainly from a fear that some industry 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 6th out of 80 industries in campaign giving in 2009; It ranked 2nd 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 level of premiums.

We have observed a wide range in the 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 private offering protocol and documentation. Some collective industry effort to create appropriate industry templates, or at least formation checklists, seems indicated in these areas to protect industry interests in minimizing future litigation and tax controversies.

Despite most of these small captives starting off initially heavily reliant on tax advantaged loss reserve build-up to address enterprise risks, 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.

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