New US "Economic Substance" Statute and Looming Captive Tax Controversies

By Tom Cifelli, JD CPA, August 5, 2012*

Introduction

Over the next several years, the new "economic substance" test combined with the rapid growth in small US insurance companies will help clarify many uncertainties regarding taxation of US insurance companies.

Political Observation

Before examining the impact of this new codification of the economic substance court doctrine, let me share my captive industry newcomer perspective on a matter of serious concern involving all of you reading this. Over the past year I have heard industry veterans and read material criticizing the growth in 831(b) captives. Their criticism stems from a fear that some captive promoters over-emphasize tax advantages and under-emphasize the economic substance and other business purposes of captives which they feel could harm the industry.

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 supportive of the industry's growth.

Broader use of captives, particularly by small to medium sized businesses (SMBs), should be encouraged even if the 831(b) incentive is what ultimately encourages, as Congress intended, captive formations. After all, most innovation and job growth will come from this SMB sector; anything that strengthens them, encourages asset reserve build-up, and improves business succession planning is a good thing and if the captive industry speaks in a unified voice in support of section 831(b) it will be preserved for a long time.

Despite some small captives starting off initially heavily reliant on tax advantaged loss reserve build-up, these smaller companies over time gain the expertise and comfort needed to expand risk management initiatives including the scope of their 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 in similar ways that retirement savings strengthen families.

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 abusive 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 significant penalties and interest. This two pronged economic substance test is not supposed to over-ride the extensive prior court cases developing the 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 diversification issues, will 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 particularly risk distribution requirements. The IRS has issued a series of pronouncements since Rev. Rul. 2005-40 clearly aimed to make it more difficult to meet risk diversification safe harbor requirements of earlier revenue rulings. Just as Rev. Rul. 2005-40 will likely be found incorrect when tested in the courts because it fails to apply substance over form and economic substance standards long honored in the courts, more recent IRS advisory memos indicating separate limited partnerships with the same general partner will be treated as one entity also ignore economic substance impacts on risk shifting and risk diversification.

When looking through the form of a transaction to see if it has economic substance suits the IRS, 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 2006 legal memo where the IRS said adding general contractors as additional named insureds did not add to risk diversification where the underlying subcontractors acts were at issue and already covered, the IRS is quick to put great weight on economic substance over form.

However when ignoring economic substance of real risk shifting and risk distribution suits the IRS view, as 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 ignores economic substance and releases pronouncements totally in contradiction of decades of court analysis focused on the economic substance of transactions.

Play It Forward~~Stay United~~

Stay focused on encouraging expanded use of captives by companies of all sizes and speak highly of the longer term benefits captives provide in the economy. It benefits no one to highlight temporary

concerns and abuses that will work themselves out as people in this industry gain sophistication in the complex legal, tax and financial issues a captive intertwines. ~~No one can have their cake and eat it too.~~

Lets hope t~~T~~he new codification of the Economic Substance Doctrine will~~will hopefully~~ help both captive industry advisors and the IRS ~~to~~ increase focus on the economic and legal substance of transactions rather than their form to achieve and allow innovations in business financial engineering to continue. Expanding use of 831(b) captives should be strongly encouraged since the SMB market sector could drive many innovations including working with forward thinking regulators who will allow efficient integration of employee benefit stop loss coverages with small captives to help make quality health coverage more affordable and more widely available to smaller employers and at the same time more clearly and directly meeting risk diversification requirements.

Fairness in applying~~on the application of the~~ substance over form rules by the IRS in the spirit of the new codified economic substance doctrine ~~from both sides~~ will help foster a healthy growing captive industry in the US and contribute to job creation and strengthening of the US~~global~~ economy.

ABOUT THE AUTHOR:
*Tom Cifelli, JD, CPA, is Managing Director of CaptiveExperts.com recently working closely on special projects with Artex Risk Solutions, one of the world's largest captive and risk management firms part of Arthur J. Gallagher (NYSE "AJG").