THE TEAM WITH THE BEST PLAYERS WINS……. Jack Welch

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The Process of Acceptance

By William York, VP of Marketing

Business ideas are often timely. The astute business leader recognizes these ideas while the average business owner remains oblivious. The IRS has continued to fight in Tax Court cases over the relevance of captive insurance companies. In more than 30 years of trying, the IRS has been able to win two court cases. You can assume these cases had to be egregious.

The two court cases we refer to are *Reserve Mechanical* and *Avrahami.*

Prior to these cases, the IRS lost in court. In the *Helvering v. LeGierse, (1941)* case it was deemed that in order for a private insurance case to be considered insurance, the arrangement must involve the following:

- risk shifting,
- risk distribution,
- insurance risk, and
- most commonly accepted ideas of insurance.

In the recent IRS victory, the IRS showed that *Avrahami* failed the test of risk shifting and also had insufficient risk distribution. Therefore, they failed to be an insurance company.

As we stated in "*The Game Changer*", available on Amazon, "in order to determine types of coverages that will be offered and pricing, you may start with a review of your client's current coverage through your existing commercial policies. But, you are by no means limited to just existing coverage. This is where the assistance of a knowledgeable, independent captive consultant can help. He or she should be able to identify the types of coverages that may best be offered through a 831(b) captive. An actuary will assist with the pricing of the policy depending on the type of coverage as well as the terms of the policy."

Again, in order for the IRS to recognize a 831(b) captive as an insurance company there must be insurance. And, again an 831(b) captive insurance company can only exist if there is risk shifting as well as risk distribution. Risk shifting is what the insured does while risk distribution is what the insurer does.

IRS Revenue Ruling 2005-40:

- "Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer."

The Revenue Ruling also states: "Courts have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risk."

It was found that *Avrahami* failed the test for both risk shifting and risk distribution and, therefore was not entitled to the tax benefits of Code Section 831(b).

The outcome of the *Reserve Mechanical* case was not much different from the *Avrahami* case. It was determined that their risk pool did not effectively provide risk distribution and was, therefore, not a "bona fide insurance company." Since it was concluded that there was an absence of risk distribution, the transactions of *Reserve Mechanical* were not believed to be insurance transactions.

Even though the *Avrahami* decision along with the *Reserve Mechanical* decision were deemed as IRS victories they are, in fact, stepping stones and learning opportunities for the astute professional.

These are only two cases. Let's look at some other decisions that were not IRS victories and are still significant learning opportunities:

- *Crawford Fitting Co. v. U.S.* (1985) – Established that insurance premiums paid to a captive by a group of separate corporations that were owned by a group of related individuals were deductible because the shareholder/policyholders of the captive were not so economically related that their separate financial transactions had to be aggregated and treated as the transactions of a single taxpayer.

- *Harper Group and Includable Subsidiaries v. Commissioner*, 96 T.C. 45 (1992) – Court rejects IRS contention that no risk shifting exists where a parent pays premium to a subsidiary to insure conduct of its own business.

- *Rent-A-Center vs. Commissioner,* 142 T.C. No. 1 (Jan. 14, 2014) – IRS overruled by Tax Court which found the captive was a bona fide insurance company despite the existence of an agreement between the parent and the captive. The parent guaranteed the captive's liabilities up to $25 million.

- 77-316 – The IRS adopts the "economic family doctrine" stating that premiums paid by a parent to a subsidiary are not deductible. However 2001-31 – IRS abandons the "economic family doctrine" acquiescing to a series of court decisions. Establishes a facts and circumstances test to determine if the captive is an insurance company.

- 2002-89; 2002-90; 2002-91 – IRS issues safe harbors to help taxpayers determine if adequate risk distribution was achieved by the captive.

- 2005-40 – IRS states that risk distribution is not met if the captive insures only one entity.

- 2014-15 – Permits companies to use captives to fund retiree health benefits without having to obtain a PLR if it meets certain requirements.

You win some…you lose some. All of this is natural and normal on the way to acceptance. This is exactly why an existing or prospective captive will need to have a professional organization such as Independent Captive Associates to help answer the questions:

- Are you a candidate for a captive insurance company (feasibility study)
- Do you know all the rules and IRS rulings that affect the formation of a captive
- Do you have a solid firm behind you to help guide you through the sometimes complicated process

One thing we know for sure – today private insurance companies are accepted as main-stream strategies and are vital for middle market business to remain relevant in these rapidly changing times. Each day we learn, we accept, and we grow.

Please call me or e-mail me to discuss any questions you may have about risk management and captive insurance companies.

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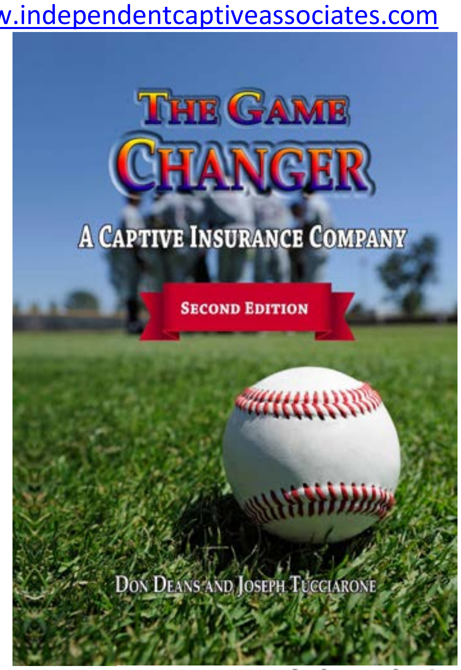

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