National Network of Accountants
RE-IMAGINING BUSINESS INSURANCE

Newsletter April 1st, 2021
Volume2, Issue 4

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BAD FACTS MAKE BAD LAW

By Paul Hyl, Esq., ACI, General Counsel

BAD FACTS MAKE BAD LAW is one of the first things you are taught in law school. It's a technique the IRS is exploiting as it continues its overly broad crackdown on *abusive* micro-captive insurance companies. The latest case decided by the Tax Court last month, *Caylor Land & Development v. Commissioner of Internal Revenue*, follows in the footsteps of the *Avrahami*, *Reserve Mechanical,* and *Syzygy* decisions, in which the Court found that the micro-captive insurance companies did not actually provide insurance because they "failed to distribute risk and didn't act as an insurer commonly would." The result being that the Court disallowed the deductibility of the insurance premiums by the operating entity and disallowed the 831(b)-election made by the captive. To the uninformed observer, this might seem to be a sign that all 831(b) micro-captive arrangements are destined to fail. However, a close look at the facts shows exactly why the IRS chose Caylor Land as the next case it would push through to trial.

Caylor Construction was a successful 60-year-old second generation construction company. Due to its success, it led to the creation of a dozen other subsidiaries and affiliates. The success of most of the related entities was closely tied to the success of Caylor Construction, and the majority of the revenue earned by more than half of the related entities was consulting income from Caylor Construction. It was not this interrelatedness of the entities alone that was the problem with the micro-captive arrangement, but the way the Caylor companies went about establishing, calculating and paying the premiums to, and operating their captive that led to the captive's downfall.

CAPTIVE FORMATION MISSTEPS

In early 2007, the owners of Caylor Construction and their long-time accountant attended a seminar on captives given by a captive manager. The captive owner's accountant advised them that the captive arrangement "sounded too good to be true," and their attorney advised them that captive insurance was a legitimate concept as long as it was "established correctly and operated correctly." Both professionals advised the captive owners that they were not qualified to advise if the tax benefits promised by the captive manager satisfied the requirements of the tax code. Despite that, the captive owners sought no further tax or legal advice on the structure and never discussed it with their long-time commercial insurance agent.

The captive insurance company, Consolidated, Inc., was incorporated on December 20, 2007, and on December 21, 2007, Caylor Construction paid $1.2 million in premiums to Consolidated. However, the Caylor entities had not yet submitted any underwriting information to Consolidated, and Consolidated had not performed any underwriting or issued any policies.

The captive manager advised Consolidated that it needed to enter into a pooling arrangement in order to achieve adequate risk distribution. The owners refused.

PREMIUM CALCULATION AND PAYMENT

The premium figure of $1.2 million was exactly equal to the maximum amount a captive insurance company could make at the time, and qualify for an 831(b) allowing it to incur no income tax on the premium payments.

At this point you might be wondering how the premium figure was arrived at. Generally, to determine the appropriate premium, actuaries look at things such as existing insurance coverages, claims history and uncovered losses. In the Caylor Land case, before establishing the captive, the Caylor entities in total spent an average of only $60,000 in annual commercial insurance premiums. Those premiums continued largely unchanged when the captive insurance was put into place, despite now spending $1.2 million on captive insurance premiums.

You might be thinking that the Caylor entities must have had a lot of uninsured risk and they were incurring significant losses that were not covered by their commercial insurance, thereby justifying increasing its overall insurance premiums by 2,000%. However, in the 10 years preceding the captive insurance, the Caylor entities averaged $50,000 a year in uninsured losses, losses that minimally certainly do not justify a $1.2 million premium to a captive!

In the middle of 2009, two Caylor entities dropped out of the Captive arrangement and two other entities replaced them. The companies that dropped out received a full refund of their premiums (despite having had coverage for part of the year). Those companies also then refunded to Caylor Construction the "consulting fees" it previously received from Caylor Construction.

Even more inappropriate, the premium amount that was refunded to the two departing entities was simply added to the premiums of the other Caylor entities, despite that such entities were not adding any additional coverage mid-year.

When it came to premiums, seven of the Caylor entities paid premiums that were equivalent to the consulting fees they received from Caylor Construction.

CAPTIVE OPERATION DEFICIENCIES

The 2007 policies were "claims made" policies, meaning they covered claims that were made during the policy period or no more than 60 days after the close of the policy year. As a result, claims would have to be presented during the last 10 days of 2007 or the first 60 days of 2008. Yet the policies had not even been provided to the Caylor entities until well after the end of that period. In all future years, the policies continued to be issued after the close of the year.

In the first 4 years of the captive arrangement, Consolidated received $4.8 million in premiums and paid four claims totaling only $43,000. Two claims were for legal fees covered by a legal expense reimbursement policy. When each claim was filed, the captive manager requested proof to support the claim, such as an invoice or proof of payment. No proof was ever submitted for either claim and despite the captive manager advising against paying such claims without proof, the captive owners paid both claims anyway. Even more mindboggling, both claims were paid before the policies were issued and even before the policies were underwritten.

IN CONCLUSION

It is no surprise that the Tax Court ruled in favor of the IRS. Captive insurance companies need to properly underwrite the policies they issue, and they need to ensure that there is adequate risk distribution, something that can easily be achieved through a proper insurance risk pool. Equally as important, captive insurance companies should pass the duck test; they should "look, swim, and quack like" a traditional insurance company.

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