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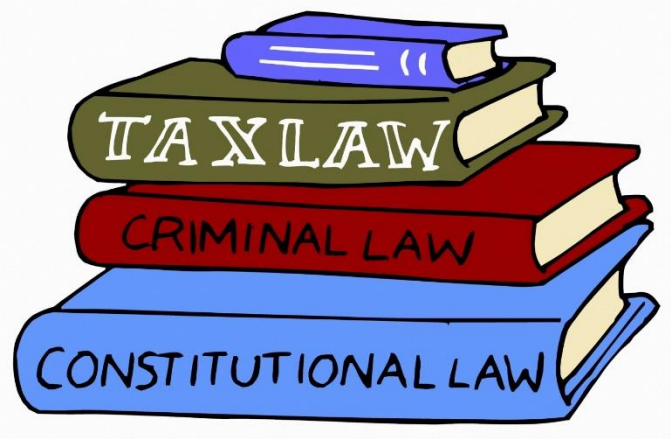
IRS Cracking Down on Abusive Micro-Captive Arrangements…and Rightfully



By Ronald M. Roth, Senior Vice President
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On July 1, 2021, the *Internal Revenue Service* issued *Notice 2021-144* entitled *"IRS Wraps Up Its 2021 'Dirty Dozen' List with Warnings About Promoted Abusive Arrangements".* This notice included a warning about *"Abusive Micro-Captive Arrangements"*. While many captive managers, promotors, and other industry pundits complain about these IRS *"attacks",* the *National Network of Accountants (NNA)* supports them wholeheartedly. When assisting a client in creation of any captive insurance company, we go to great lengths to ensure the captive arrangement is compliant, and the client has a suitable risk profile for captive insurance.

In addition to our captive management and consulting businesses, we also assist accounting firms with their clients who have micro-captive arrangements, not facilitated by our firm, but being audited by the IRS. This experience has been an important reminder of how abusive some 831(b) Micro-Captive insurance company arrangements can be, and that the IRS is rightfully attempting to stop such abuses.

The Supreme Court Weighs In

On May 17,2021, the United States Supreme Court reinforced the legitimacy of 831(b) Micro-Captive arrangements with its decision in *CIC Services v. Internal Revenue Service*. In the unanimous opinion for the Court, Justice Elena Kagan stated:

> *"A micro-captive transaction is typically an insurance agreement between a parent company and a 'captive' insurer under its control. The Code provides the parties to such an agreement with tax advantages. The insured party can deduct its premium payments as business expenses. See §162(a). And the insurer can exclude up to $2.2 million of those premiums from its own taxable income, under a tax break for small insurance companies. See §831(b).* ***The result is that the money does not get taxed at all. That much, for better or worse, is a congressional choice*** *(emphasis added)".*

While the court clearly points out that micro-captive arrangements are allowable under the law, Justice Kagan goes on to say:

> "*But no tax benefit should accrue if the money is not really for insurance—if the insurance contract is a sham, which the affiliated companies have entered into only to escape tax liability. And according to the IRS, some micro-captive transactions are of that kind."*

So, we are back to our original premise that the problem is not with 831(b) Micro-Captives in general, rather it's with those deemed by the IRS to be *abusive*. When attempting to determine whether or not a captive insurance arrangement is legitimate or abusive there are *tangible* and *intangible* attributes that must be present. Tangible attributes include requirements clearly communicated by the courts and the Service such as risk shifting and risk distribution.

Risk Shifting & Distribution

The requirement of risk shifting simply stated is that the risk of loss must be shifted from one person, the insured, to another, the insurer. Courts have described risk shifting in stating a required aspect of insurance is the "transferring from the insured to the insurer the consequences of a possible future event." From an economic standpoint, if the insured no longer bears the full risk of loss, that loss has been shifted to another.

While risk shifting looks at the arrangement and risk from the perspective of the insured, risk distribution looks to the insurer to see if the risks acquired by the insurance company are distributed among a pool of risks such that no one claim can have an extraordinary adverse effect on the insurer. In *Revenue Ruling 2002-90*, the IRS held proper risk shifting was present in a case where the parent company with 12 operating subsidiaries formed an insurance company subsidiary for the purposes of insuring professional liability risks of the 12 other subsidiaries. This ruling establishes a clear *safe harbor* for practitioners to follow.

Intangible Characteristics

In order for a micro-captive insurance company to be treated as a bona fide *insurance company* for tax purposes, it must function in a manner that is consistent with traditional insurance companies from an operational point of view.

The following *intangibles* that should be present in any micro-captive insurance company arrangement:

- All risks covered by the captive should be appropriate for the business and industry being insured and should not duplicate commercial coverage.
- Insurance policies written by the captive must be priced appropriately and be based upon reasonable and acceptable actuarial assumptions.
- A captive insurance company must pay claims. Any year that goes by in which a captive does not pay any claims is problematic.
- Claims review and payment methodology must be done in an organized manner. Insurance companies must handle claims as they are submitted and on a timely basis. Ad hoc claims
- treatment and inconsistent review and approval procedures are also problematic.
- Captives must be capitalized appropriately based upon the rules of the jurisdiction in which its domiciled.
- The captive must have an *Investment Policy Statement* and investment of captive assets must be suitable based upon the captive's reserve requirements and surplus status.
- Captives should be very careful in making loans. Funds deemed as reserves should almost never be loaned and loans, even of surplus, back to the insured company or its owners should be discouraged.

If the above guidelines are followed, 831(b) Micro-Captive insurance companies can compliantly operate in the manner in which congress intended when it passed and updated captive legislation. This is one area of the law that enjoys bi-partisan support on Capitol Hill and has, as we discussed, been recently addressed favorably by the United States Supreme Court. The IRS will continue to crack down on abusive arrangements until there is more widespread compliance industry wide.

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