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ABUSIVE MICRO-CAPTIVES

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Since the first "captive" was established in 1957, the IRS has viewed this alternative approach to insure business risk, with a jaundiced eye.

Captives are private insurance companies established by a corporation in order to assist in handling insurance demands. They are what insurance professionals classify as part of the Alternative Risk Transfer component of business insurance.

Alternative Risk Transfer: The marketplace in which nontraditional risk transfer approaches (as compared to commercial insurance) can be arranged. Some types of entities and approaches included in this marketplace are captive insurance companies, pools, and risk retention groups (RRGs.)

AM Best indicates that the Alternative Risk Transfer market is the largest premium segment of the insurance industry (over 56% of every insurance dollar is placed in an ART market.) Forbes indicates that over 90% of Fortune 500 companies utilize Alternative Risk Transfer through the use of captive insurance companies.

As the captive marketplace expanded from the initial captive created in 1957, President Ronald Reagan, in the mid-1980s, took a bold step in giving smaller businesses protection by exempting the first $1.2 million of premium from taxation. This was done to get smaller companies involved in captives and with an understanding of the complexity and cost associated with the creation of an insurance company. These captives were termed micro-captive. In other words, $1.2 million dollars could be paid to your own insurance company – captive to your sponsoring company. Furthermore, these monies would not be considered income to the captive. The IRS responded with multiple lawsuits which continued for almost 14 years until the early 2000s. They lost many cases of which we can elaborate if this information is needed and requested.

After initially focusing on captives in general, the IRS began focusing solely on micro-captives. Why? Maybe because smaller companies did not have the resources that the major companies in America had. Smaller companies could be intimidated. Also, they did not have the manpower and resources that the larger companies possessed.

However, they do have the same insurance issues as many of the larger companies. Smaller companies are more vulnerable than larger companies. However, they are the backbone of the American economy.

Check the facts on ready.gov.

As would be imagined – micro-captives continued to grow.

A captive insurance company is a subsidiary that is formed by a company to finance the company's retained losses in a formal structure under the guidance of an appropriate state insurance department.

Insurance is a state issue and many states stepped up to help these local businesses. Stronger and more resilient businesses can help state economies on multiple levels.

Specifically, a micro-captive insurance company is a captive insurance company that qualifies under Sec. 831(b) allowing it to enjoy a variety of tax benefits. This is no different than Congress encouraging businesses to set up retirement plans by allowing deductions for pension contributions or allowing deductions for mortgage interest, etc. However, unlike the traditional support given by Congress, the Treasury and the IRS believe micro-captive transactions have a potential for tax avoidance or evasion.

There is no doubt that this is true. Unscrupulous individuals need to be removed from this area. The question is how?

The IRS, admittedly, lacked sufficient information that defined the characteristics that distinguish the tax-avoidance transactions from properly formed Sec. 831(b) related party transactions.

In 2016, to address this issue, the IRS issued Notice 2016-66 in which it indicated that micro-captive insurance transactions that are the same as or substantially similar to the transaction described in the notice, would be considered “transactions of interest.” These transactions would require information reporting as “reportable transactions” under Regs. Sec. 1.6011-4 and Secs. 6011 and 6012 for taxpayers engaging in the transactions and, material advisers with respect to those transactions.

This event, and the inclusion of captives on the IRS Dirty Dozen list, resulted in more confusion. It is hard to even imagine that if Congress wanted to assist businesses with their insurance problem, and multiple state governments were reviewing and approving captives, that the IRS would not take a more inclusive approach and attempt to support Congress and American businesses.

Within no time at all the lawsuits started coming and any “good will” was out the window. Fast forward another 5 years and a captive manager, with some limited assistance from selective organizations, succeeded in obtaining a judgement setting aside the 2016-66 notice.

So, where are we today and what steps should be taken by a company that employs an 831(b) captive?

1. Realize that the court actions for 2016-66 are not over and continue to comply with the provisions.
2. Operate your micro-captive properly. Use third party vendors and act responsibly.
3. Recognize that micro-captives are part of the law. They are supported by the Executive Branch of the government and the Legislative Branch … They are here to stay.
4. Support the captive industry’s political and financial efforts currently going on to remedy this miscarriage.
5. When your micro-captive is set up, create insurance to cover any possible government audits.
6. Get behind CIC Services LLC leadership in their continued effort to establish uniformity and clarity in this area.

I can and will say publicly, “Thank You” to Sean King and CIC Services LLC. Without their leadership we would still be in a legislative wasteland. Your effort is creating a light at the end of a long tunnel.

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