HISTORY REPEATING ITSELF: THE IRS AND CAPTIVE INSURANCE

The IRS has a long history of disapproving captive insurance arrangements, beginning in the late 1970s. The focus that enterprise risk captives (ERCs) are experiencing now from the Service mirrors what happened decades ago.

Written By Karrie Hyatt

While captives have existed since the 1940s, they began to flourish in the 1970s. Single-parent captives and group captives were an important solution to the hard insurance markets during the 1970s and 1980s.

As the sector grew, the IRS began to take notice of captives, particularly large single-parent captives. The IRS's position on single-parent captives was that those captives were not providing insurance, as the arrangement related the captive too closely to its parent and the parent company's subsidiaries. The IRS claimed that the premiums paid could not be deducted from the parent or subsidiaries' taxes.

The Service codified this position in 1977 in Revenue Ruling 77-316 which called the relationship between parent, subsidiaries, and captive an "economic family." Their position was substantiated in 1978 in the case of *Carnation Co. v. Commissioner*. In the decision, the U.S. Tax Court found in favor of the IRS's argument that the captive was too closely related and that the captive was not adequately capitalized to be an insurance company.

According to Charles J. Lavelle, partner with Dentons Bingham Greenebaum LLP, "The tax lawyers at the time knew that the 'economic family' theory had no historical precedent. Even though the IRS won early captive cases, no court ever adopted economic family, and the IRS ultimately abandoned it."

During the 1980s, the IRS had several more wins in the tax court—*Stearns-Roger v. Commissioner* and *Clougherty Packing v. Commissioner* were two more well-known cases—which continued to strengthen its "economic family" theory.

Regardless of these tax court losses, large single-parent captives were forming at an accelerated rate. The hard insurance market in the 1980s encouraged companies to turn to captive insurance programs as a viable alternative to the commercial market, despite the IRS's issues.

"The insureds needed the insurance coverage and/or felt they could prosper from the other aspects of captive insurance (e.g., capture the profits of the commercial market, control over claims handling, etc.)," said Lavelle. "For instance, Humana could not obtain medical malpractice for its hospitals from the commercial market, and considered several options before selecting a single-parent captive."

It wasn't until 1989 that the IRS suffered a loss in tax court. In *Humana v. Commissioner*, the Sixth Circuit Court of Appeals found in favor of Humana's captive structure based on the new idea that a captive and the subsidiaries it insures are in a "brother-sister" relationship, which undermined the IRS's "economic family" position.

The "brother-sister" relationship posits that as each subsidiary of a parent company is its own entity as recognized by the tax court (i.e. they each file their own taxes making them an individual in terms of taxation), when a captive insures that subsidiary there is enough distance in the relationship that risk distribution is achieved. The decision allowed for subsidiaries to deduct their premiums paid to the captive, but not the parent company.

Humana's big win influenced more captive tax court wins in the early 1990s, all of them using the "brother-sister" position of risk distribution.

However, it wasn't until 2001 before the IRS officially dropped its position on "economic family" in Revenue Ruling 2001-31.

Alan J. Fine, tax partner, Armanino LLP said, "I think that the industry as a whole felt that the IRS was blatantly wrong and courts were agreeing with them. If you think about it in hindsight, the IRS didn't win a captive case pretty much after 1992 or 1993 until Avrahami."

As to why it took so long for the IRS to disavow its "economic family" theory, the Service works very slowly. "Things take a long time at the IRS, which had to follow a four-step process. First, a consensus had to develop within the IRS to stop the audit initiative against the large captives, then the IRS had to internally decide that it would abandon 'economic family,' this was followed by a decision that the IRS would agree that captives can have insurance for tax purposes, and finally the IRS had to draft the Revenue Ruling to announce its official position. Each step required decisions by IRS executives, who had responsibility over a very wide variety of issues, not just the captive issue," said Lavelle.

The IRS was still very much interested in the risk distribution aspects of captive insurance companies. In 2002, the Service released three revenue rulings that focused on unrelated business and risk distribution. Revenue Ruling 2002-89 deemed that 50% unrelated risk would qualify as adequate risk distribution.

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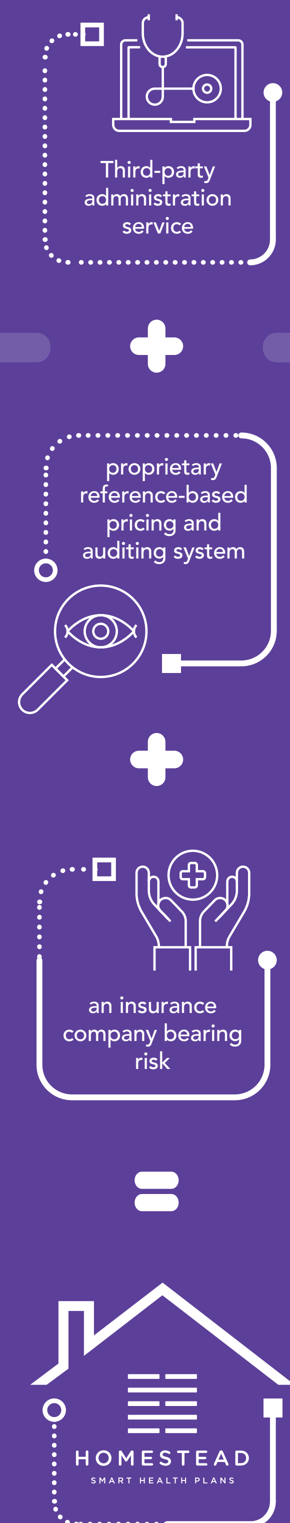

Revenue Ruling 2002-90 stated that 12 or more subsidiary companies in a "brother-sister" relationship, with no one company contributing more than 15% of the total premium, counted as sufficient risk distribution.

Revenue Ruling 2002-91 suggested that in group captives seven or more unrelated entities was enough for risk distribution. There was no reason given why seven equaled appropriate risk distribution for group captives, but twelve was the number required for single-parent captives.

With its "economic family" theory revoked, the IRS focused more closely on risk distribution for large single-parent captives in the early 2000s, and then on ERCs later in the decade.

In 2014, the IRS lost two important cases regarding single-parent captives and risk distribution—*Rent-A-Center, Inc. & Affiliated Subsidiaries v. Commissioner* and *Securitas Holdings, Inc. & Subsidiaries v. Commissioner*. In these two cases, the tax court found that while the IRS focused on number of subsidiaries insured for risk shifting and risk distribution, insurance companies looked at the unit number of risks being insured. When looked at from the insurers point of view, risk distribution is more than adequate.

According to Fine, "The courts had historically focused on entities being insured rather than on units being insured, so the IRS never thought they would lose those cases. Then the tax courts said, you don't look at insurance from the number of insureds, you look it at from the insurance company's perspectives and how many risks are they insuring. If they are insuring a sufficient number of independent risks then you have risk distribution."

Large single-parent captives have not been a focus of the IRS since the early 2010s, especially after their losses in tax court in 2014.

However, most industry professionals do not think that the IRS is done with those types of captives. "I think the Service is temporarily focused elsewhere, but they don't like captives. They've told us that face-to-face when we went in to talk to them about issues with the 831(b) captives. They began the conversation by telling us that they don't like captives and they suspect they never will. I don't think they are done with [large] single-parent captives, I think they are focusing on something else for the time being," said Jeffrey K. Simpson, partner with Womble Bond Dickinson (US) LLP.

According to John R. Capasso, president and CEO, Captive Planning Associates, LLC, "I honestly do not think the IRS will ever give up their quest of harassing single parent captive owners. Its unfortunate, because companies that are willing to assume risk in their own captive, assuming proper risk shifting and risk diversification, are saying that they understand the nature of the their own risk and can manage such risk better than a third-party that has little, if any, vested interest. For the business, it should translate into a stronger balance sheet enabling management to better manage cash flow and, ultimately, earnings."

For Lavelle, there are three reasons he believes the IRS will again turn their scrutiny towards large single-parent captives. "First, the IRS has never liked captives (large or small). Second, the recent court opinions [involving captives] have some statements that might be used against large captives. Third, the IRS has built an infrastructure of agents and insurance specialists who understand insurance, that the IRS could deploy against large captives."

The IRS turned its attention towards ERCs taking the 831(b) tax election in the early 2010s. They began an aggressive audit campaign against them, that was followed by the IRS naming microcaptives, what they call ERCs, to its annual "Dirty Dozen" list of what they consider tax scams. Notice 2016-66 followed soon after which named microcaptives as "transactions of interest" and required additional, burdensome information from ERCs.

However, the IRS's tax court history with single-parent captives might begin to repeat itself. In 2017, the captive sector experienced its first loss in U.S. Tax Court to the IRS in *Avrahami v. Commissioner*. This was followed by two additional losses the following two years with *Reserve Mechanical Corp. v. Commissioner* and *Syzygy Insurance Co. v. Commissioner*. The *Reserve Mechanical* case is being appealed, so there is some possibility that the original decision might be overturned.

Then late last year, the IRS conceded a tax court petition that been filed by Puglisi Egg Farms of Delaware, LLC. The concession indicated that the IRS knew that they were not going to be able to win in the tax court. While not as precedent setting as a U.S. Tax Court decision, the IRS's concession implied to the captive insurance sector that there are captive insurance arrangements that are acceptable to the Service.

"The IRS will say that there are valid captive insurance arrangements, but their actions speak louder than words," said Fine. "When you are dealing with an examination, the IRS will assume that everything is bad until you prove otherwise and you're not able to prove otherwise unless you litigate. That's how we got the result in Puglisi. The IRS conceded because they knew they were going to lose."

An interesting aspect to note is that, so far, the IRS has not focused its attention on group captives, other than through a few revenue rulings. In 1978, the IRS released Revenue Ruling 78-338, which addressed how many members a group captive needed to achieve proper risk distribution. Revenue Ruling 2002-91, one of the three pertinent rulings in 2002, stated that seven or more entities should make up a group captive to create appropriate risk distribution.

Why hasn't the IRS been as keen to audit group captives as other types of captives? For Lavelle, "The IRS assumes that because a group captive has numerous unrelated participants, none of whom dominates the group captive, that the premiums, sharing arrangements, claims processing and other aspects will be conducted at arms' length."

"Risk distribution is a necessary component of insurance and a key criteria in determining whether an arrangement constitutes insurance for federal income tax purposes," said Capasso. "By their very nature group captives establish risk distribution by providing for sharing of risk among numerous unrelated policyholders."

Simpson thinks there are three reasons. "One is that group captives typically cover risk that the insureds are otherwise covering in commercial programs. They are just replacing those commercial programs, so it's considered insurable risk. The second reason is that it is a group sharing risk, distributing it across themselves. That is what everyone considers the definition of insurance. Third, companies really don't tend to accumulate any profit in those programs. The IRS really doesn't like captive insurance companies that accumulate profit. The Service thinks if a captive is spending all of its money to pay for losses that's a good thing. Group captives typically do that."

"The IRS feels like there is less potential for abuse in the group captive setting," said Fine. "What I would caution, for people to keep in mind is that some time they're going to finish up with the small captives, one way or another. All of these issues they are raising they can then take the same approach and apply it to group captives."

While the IRS has some significant wins in the tax court regarding captives taking the 831(b) exemption, the hope is that the pendulum will swing back in favor of those captives as happened in the early 1990s with large single-parent captives.

It is Capasso's hope that this happens, "History has shown that it will take time and diligence. The ability for small to mid-sized companies to purchase hard to insure, high cost coverages—such as business interruption insurance due to a pandemic, or cyber liability insurance in case of a cyber- attack—could be the difference in the business surviving such an economic calamity or catastrophic event. This is especially so in the event government is unwilling or unable to offer bail-out funding. The small captive, properly capitalized and holding sufficient reserves may be the only life-line the business has."

Whether or not the IRS gives up its campaign against ERCs, they will likely continue to scrutinize captive arrangements well into the future. "There's always going to be tension between the IRS and captive insurance because the captive insurance industry exists to be creative, to solve new problems, and to do new things that haven't been done before," said Simpson. "What the IRS wants is for everything to fit into the same mold they've always seen. If it's a different mold, they think it's a trick." ■