



12 TAX PRACTICES AND PROCEDURES FOR CAPTIVES

Bennett Thrasher's Laurie Bizzell provides tax guidance for US captives

It is time for captives to perform a health check of their current structure and operations based on the IRS' aggressive focus and examination of captive insurance arrangements. Despite landing on the IRS' annual 'Dirty Dozen' list for the 5th consecutive year, captive insurance companies (including micro-captives) continue to be a viable strategic vehicle for businesses looking to have more control over their risk management function. The IRS warns taxpayers to "steer clear" of "abusive" micro-captive insurance arrangements. This begs the question, how does a taxpayer 'steer clear' of 'abusive' captive insurance arrangements and still use the non-tax benefits associated with a captive as a cost-efficient risk management tool?

Captive owners and practitioners should focus on getting back to basics when establishing and operating a captive insurance company to remain in compliance with the IRS' stated positions set forth in administrative rulings and the Tax Court's views over the past several decades.

The following is a practical checklist of 12 healthy tax practices and procedures that will not only help captives prepare for a potential IRS audit, but also ensure that captives are truly maximizing the risk management benefits.

1. Ensure the arrangement involves 'insurance risk': fundamentally, 'insurance risk' exists when an insured faces some risk of loss and an insurer accepts a premium to perform some act when and if the loss occurs. The courts have found that contracts containing 'investment

Laurie Bizzell



risk' or 'business risk' alone are insufficient.

2. Ensure the arrangement provides for 'risk-shifting': 'risk shifting' occurs when an insured transfers a discrete risk to an insurer such that the risk of loss passes from the insured to the insurer. In essence, the loss has shifted from one legal entity to another.

3. Ensure that the arrangement provides the requisite 'risk distribution': the courts and IRS have put forth an inconsistent view of whether the number of insured entities or insured events is determinative in analysing the risk distribution issue. It is the author's view that both can provide for the distribution of risk based on the facts.

4. Ensure the captive is operating as an insurance company in its 'commonly accepted' sense: no one factor is determinative, but generally, the captive is organised, licensed and regulated as an insurance company along with additional factors noted below.

5. Ensure arm's length premiums are established according to customary industry rating formulas, focusing on the premise that a cost-efficient risk management vehicle should reduce the overall cost of insurance, while providing for control over the risk management programme to minimise the risk exposures.

6. Ensure insurance policies are timely executed and legally binding, and that policy premiums are less than the potential losses on the policy limits.

7. Ensure the parent does not provide any guarantees of the captive's performance.

8. Ensure all funds and business records are kept separately and managed consistently with standards applicable to unrelated parties, often through the use of an independent captive manager.

9. Ensure formal policies and procedures are in place for submitting claims for losses incurred and that claims are paid in accordance with the policies.

10. Ensure insured claims are actually submitted and paid in a timely manner by the captive.

11. Ensure the captive not only meets the minimum capitalisation requirements, but also has sufficient capital to cover the insured losses.

12. Ensure investments made by the captive can provide for liquidity and generate income to fund losses.

As a strategic risk management vehicle, captives should enhance or replace existing coverage and improve asset protection. A captive insurance company should also decrease insurance costs, including access to reinsurance coverage and excess cost. In light of the IRS' current focus and scrutiny of micro-captives, captive owners and practitioners will want to perform a health check by reviewing their current or prospective captive insurance arrangements by taking into consideration the above checklist. 🌱