BENNETT THRASHER LLP

The Captive Insurance Tax Landscape in 2019

It is critical for clients and practitioners to appreciate the Internal Revenue Service's ("IRS") historic positions and analysis regarding captive insurance companies, in order to fully understand the current captive insurance tax environment. The following discussion focuses on the relevant authorities contained in the Internal Revenue Code and Regulations, the current views of the IRS as set forth in administrative rulings and pronouncements and decisions dealing with what transactions qualified as insurance, and whether the activities of a related captive insurance company are those of a company primarily and predominately engaged in the insurance business.

Characterization as Insurance for Federal Income Tax Purposes

IRC Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business…" Generally, insurance premiums qualify as ordinary and necessary if directly connected with the taxpayer's trade or business.[i] Amounts set aside as reserves for the payment of anticipated losses are not deductible business expenses.[ii]

In determining whether a transaction qualifies as insurance, one must turn to judicial precedent as the Code and Regulations are silent on the matter. According to the U.S. Supreme Court in *Helvering v. Le Gierse*,[iii] a valid insurance contract requires the presence of insurance risk and involves both risk shifting and risk distribution. In 1991, the United States Tax Court expanded this definition of insurance[iv], establishing a three-part test for determining whether an insurance contract exists:

- Whether the arrangement involves an insurance risk;
- Whether the arrangement provides both risk-shifting and risk distribution; and
- Whether the arrangement is insurance in its commonly accepted sense.

Case law has defined an insurance contract as "a contract whereby, for an adequate consideration, one party undertakes to indemnify another against loss arising from certain specified contingencies or perils. . . [I]t is contractual security against possible anticipated loss."[v] The risk transferred under the contract must involve the assumption of another's risk of economic loss.[vi]

The Internal Revenue Service's Analysis of Captive Insurance

Historically, the IRS concluded that premiums paid to a captive insurance company were not deductible as ordinary and necessary business expenses under IRC Section 162(a) based upon the 'economic family' theory which was centred on the premise that an insurance contract between an insured and a captive insurer lacks the requisite risk shifting to qualify as true insurance.

A Limited Liability Partnership of Certified Public Accountants & Consultants
Riverwood 200 3300 Riverwood Parkway Suite 700 Atlanta, GA 30339 **phone** 770.396.2200 **fax** 770.390.0394
www.btcpa.net

Revenue Ruling 2001-31

However, in 2001 the IRS announced in Revenue Ruling 2001-31 that it would no longer invoke its 'economic family' theory when addressing the premium deductibility issue of captive insurance transactions. This ruling made obsolete or modified several prior captive rulings.[vii] Nonetheless, the ruling stated that the Service would continue to challenge certain captive insurance transactions based on the facts and circumstances of each case. In addition, the Service also stated that it would continue to pursue parent-subsidiary captive relationships, citing *Clougherty Packing Company v. Commissioner*[viii] and those arrangements where the "taxpayer guaranteed the captive's performance and the captive was thinly capitalized and loosely regulated".

Revenue Ruling 2002-89

In December 2002, the IRS published three Revenue Rulings which dealt with captive insurance companies.[ix] In Revenue Ruling 2002-89, the Service ruled on the issue of the deductibility of premiums paid by a parent to its wholly owned captive subsidiary. The Service addressed the issue using two fact patterns. In situation 1, 90% of the premiums received by the captive were received from the parent of the captive and 10% was received from unrelated third parties. In situation 2, the premiums received from the parent by the captive constituted less than 50% of the total premiums received and more than 50% was received from unrelated third parties. The Service ruled that the arrangement in situation 1 lacked the requisite shifting and risk distribution to constitute insurance for federal income tax purposes. Hence, the premiums were not deductible. In situation 2, the Service relying on the holdings in *Ocean Drilling*[x] and *AMERCO*[xi], ruled that risk shifting and distribution were present, and therefore, the premiums paid were deductible. In addition to the captive receiving more than 50% its premiums from unrelated third parties, the ruling contained other important factors including the following:

- The premiums were established according to customary industry rating formulas,
- The parties conducted themselves consistently with the standards applicable to an insurance arrangement between unrelated parties,
- The parent did not provide any guarantees of the captive's performance,
- All funds and business records were kept separately, the risks were homogeneous and
- The captive did not loan any funds to the parent.

Revenue Ruling 2002-90

In Revenue Ruling 2002-90, twelve geographically dispersed subsidiaries of a common parent company (each subsidiary operated in a separate state) insured their professional liability risks with a captive insurance company (also owned by the common parent). The IRS ruled that the payment of premiums by the 12 separate subsidiaries to the captive did result in risk shifting and that the transaction did constitute insurance for federal income tax purposes. The IRS relied upon the courts in *Humana*[xii] and *Kidde*[xiii] in reaching its conclusions. Revenue Ruling 2002-90 provided confirmation that the IRS would respect an insurance arrangement between 'brother-sister' entities.

<u>Revenue Ruling 2002-91</u>

In Revenue Ruling 2002-91, the IRS set forth circumstances under which a group captive of unrelated insured entities qualified as an insurance company. A taxpayer, X, and a significant number of the businesses involved in X's industry (Members) formed a so-called 'group captive' (GC) to provide insurance coverage for stated liability risks. The GC provided insurance only to X and the other Members. The business operations of GC were separate from the business operation of each Member. In addition, GC was adequately capitalized.

No Member owned more than 15% of GC, and no Member had more than 15% of the vote on any corporate governance issue. In addition, no Member's individual risk insured by GC exceeded 15% of the total risk insured by GC. Thus, no one member controlled GC. The IRS concluded that X could deduct premiums paid to GC as insurance.

The Internal Revenue Service's Current Tax Environment

<u>Notice 2016-66</u>

In Notice 2016-66[xiv], the IRS identified certain captive insurance transactions as "transactions of interest" (e.g. 'micro-captive' insurance transactions, also known as IRC Section 831(b) insurance companies), which required the person involved in the transaction to disclose it to the IRS on Form 8886 to avoid penalties. Additionally, the IRS has continued to express concern over certain 'micro-captive' insurance transactions (e.g. IRC Section 831(b) captive insurance companies) and included them in their annual 'Dirty Dozen' list.[xv]

Notice 2016-66 provided characteristics of certain 'micro-captive' insurance transactions that concern the IRS, including uneconomic premiums (e.g. not arm's length and actuarially determined), failure to comply with the terms of the insurance contract, implausible insurance risks, not complying with regulatory requirements, thinly capitalized captives, Captive invests in non-traditional insurance investments (e.g. illiquid or speculative assets) and captive loans or otherwise transfers money to insured (e.g. loan-backs, guarantees, etc.).

As noted above, the IRS has historically challenged captive insurance arrangements and, as such, there is inherent risk in any captive insurance transaction that is heightened with respect to 'micro-captive' insurance arrangements. The Treasury Department and IRS recognized in Notice 2016-66 that not all 'micro-captive' insurance transactions are abusive. However, considering Notice 2016-66 and the IRS' identification of 'micro-captive' insurance transactions on the annual 'Dirty Dozen' list, IRC Section 831(b) captives need to assess the application of Notice 2016-66 and their status as insurance companies.

Recent Cases

More recently, the IRS challenged captive insurance companies in both *Avrahami v. Commissioner*[xvi] and *Reserve Mechanical Corp. v. Commissioner*[xvii]. After three decades of losing cases involving captive insurance, the IRS considers the decisions in *Avrahami* and *Reserve Mechanical* a win in their favor. In *Avrahami*, the court determined that the arrangement did not constitute insurance for federal income tax purposes. As such, the court concluded that the amounts paid as insurance premiums were not deductible under IRC Section 162, and the IRC Section 953(d) and IRC Section 831(b) elections were invalid. The court's decision was based on the fact that it determined the captive did not distribute risk and the arrangement was not insurance in its commonly accepted sense.

The court in *Reserve Mechanical* concluded that the arrangement did not constitute insurance for federal income tax purposes and as such, the court determined that the amounts paid as insurance premiums were not deductible under IRC Section 162, and the IRC Section 953(d) and IRC Section 501(c)(15) elections were invalid. Again, the court's decision was based on the fact that it determined the captive lacked both the requisite risk distribution and the common notions of insurance.

In light of the recent developments with Notice 2016-66, *Avrahami*, and *Reserve Mechanical*, the Service continues to pursue captive insurance cases based upon the judicial standard of insurance, as set forth by the Supreme Court in *Le Gierse* and modified by the Tax Court in *Sears*, *AMERCO* and *Harper,* which calls for the determination of:

- Whether the arrangement involves an insurance risk;
- Whether the arrangement provides both risk-shifting and risk distribution; and
- Whether the arrangement is recognized as insurance in its commonly accepted sense.

What You Should Do

Taxpayers will want to review their current or prospective captive insurance arrangements taking into consideration the Tax Court's three-part test in determining what constitutes insurance for federal income tax purposes. In addition to the three-part test above, taxpayers will also want to consider the totality of the facts including whether the premiums were established according to customary industry rating formulas, the parties conducted themselves consistently with the standards applicable to an insurance arrangement between unrelated parties, the parent did not provide any guarantees of the captive's performance, all funds and business records were kept separately, the risks were homogeneous and the captive did not loan any funds to the parent.

Contact Us

Should you have questions about the IRS' current tax landscape of captives, structuring opportunities for a captive or a health check of your existing captive insurance company, contact Laurie Bizzell by calling 770.396.2200.

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[i] Treas. Reg. § 1.162-1(a).
[ii] *Spring Canyon Coal Co. v. Commissioner*, 13 B.T.A. 189 (1928), 43 F.2d 78 (10th Cir. 1930), *cert. denied* 284 U.S. 654 (1931); *Pan-American Hide Co. v. Commissioner*, 1 B.T.A. 1249 (1925).
[iii] *Helvering v. Le Gierse*, 39 B.T.A. 1139 (1939), *aff'd* 110 F.2d 734 (1940), *rev'd* 312 U.S. 531 (1941).
[iv] *AMERCO and Subsidiaries v. Commissioner*, 96 T.C. 18 (1991), *aff'd* 979 F.2d 162 (9th Cir. 1992); *Sears, Roebuck and Co. and Affiliated Corps. v. Commissioner*, 96 T.C. 61 (1991), *mod'd and suppl'd* 96 T.C. 671 (1991), *aff'd in part and rev'd in part* 972 F.2d 858 (7th Cir. 1992); and *Harper Group and Includable Subsidiaries v. Commissioner*, 96 T.C. 45 (1991), *aff'd* 979 F.2d 1341 (9th Cir. 1992).
[v] *Epmeier v. United States*, 199 F.2d 508, 510 (7th Cir. 1952).
[vi] *Allied Fidelity Corp. v. Commissioner*, 66 T.C. 1068 (1976), *aff'd*, 572 F.2d 1190 (7th Cir. 1978); Rev. Rul. 89-96, 1989-2 C.B. 114.
[vii] Rev. Rul. 77-316, 1977-2 C.B. 53; Rev. Rul. 78-277, 1978-2 C.B. 268; Rev. Rul. 88-72, 1988-2 C.B. 31; and Rev. Rul. 89-61, 1989-1 C.B. 75, are obsoleted.; Rev. Rul. 78-338, 1978-2 C.B. 107; Rev. Rul. 80-120, 1980-1 C.B. 41; Rev. Rul. 92-93, 1992-2 C.B. 45; and Rev. Proc. 2000-3, 2000-1 I.R.B. 103, are modified as a result of the issuance of Rev. Rul. 2001-31.
[viii] *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985), aff'd, 811 F. 2d 1297 (9th Cir. 1987).
[ix] See Revenue Rulings 2002-89, 2002-90 and 2002-91.
[x] *Ocean Drilling & Exploration Co. v. U.S.,* 988 F.2d 1135 (Fed. Cir. 1993).
[xi] *AMERCO, Inc. v. Commissioner,* 979 F.2d 162 (9th Cir. 1992).
[xii] *Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989).
[xiii] *Kidde Industries, Inc. v. United States,* 40 Fed. Cl. 42 (1997).
[xiv] 2016-47 IRB
[xv] See IR-2016-25 and more recently IR-2018-62
[xvi] *Avrahami v. Commissioner*, 149 T.C. 7 (2017)
[xvii] *Reserve Mechanical Corp v. Commissioner,* T.C. Memo 2018-86 (2018)